

IX. DISCLOSURE-RELATED DEFICIENCIES AND VIOLATIONS OF LAW: PENSION AND WASTEWATER

The City and SDCERS provided public disclosures about pension obligations and wastewater compliance that were incomplete, inaccurate, and misleading from 1996 through 2003. The following describes those deficiencies.

A. The City's Disclosure Process

The City of San Diego, as an issuer of securities to the public, provided information to the marketplace and to its citizens concerning the financial health of the City and the City's ability to fulfill its obligations to bondholders in three principal ways: (a) the Comprehensive Annual Financial Reports for the City and SDCERS; (b) offering statements and other disclosure documents in connection with City bond offerings; and (c) presentations to rating agencies that analyzed the City's creditworthiness and provided reports to investors.⁹⁰⁰

1. The Comprehensive Annual Financial Report

The City CAFR, which was usually released toward the end of the calendar year, consisted of financial and statistical information for the City's prior fiscal year, ending June 30th.⁹⁰¹ The audited "Financial Section" contained both an overview of the City's general-purpose financial statements for all City funds combined – including balance sheet information, revenues and expenses, and cash flow position – and similar information for each individual City fund.⁹⁰² The financial section also contained a "Notes" section, consisting of supplemental information about the financial condition of certain City programs, accounting methods underlying the City's finances, and other matters not reflected in the numerical financial statements.⁹⁰³ The non-audited "Statistical Section" contained data showing ten-year trends in the City's

⁹⁰⁰ The City also issued Annual Reports to holders of its bonds as part of its continuing disclosure obligation for outstanding bond issues. 17 C.F.R. § 240.15c2-12(b) (2006). *See, e.g.*, Annual Report for the Fiscal Year Ended June 30, 2002 Relating to \$169,685,000 Public Facilities Financing Authority of the City of San Diego Lease Revenue Bonds, Series 2002 (Ballpark Project) (Apr. 8, 2003).

⁹⁰¹ *See, e.g.*, City of San Diego, California, Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 1997 (Nov. 21, 1997).

⁹⁰² *See, e.g.*, City of San Diego, California, Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 1997, at 1 (Nov. 21, 1997).

⁹⁰³ *See, e.g.*, City of San Diego, California, Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 1997, at 18-1 (Nov. 21, 1997).

expenditures, revenues, and bonded debt, among other items.⁹⁰⁴ From fiscal year 1997 to 2002, the Pension Plan note of the City CAFR contained the following reference to SDCERS financial reports: “SDCERS is considered part of the City of San Diego’s financial reporting entity and is included in the City’s financial reports as a pension trust fund. SDCERS issues a stand-alone financial report which is available at its office.”⁹⁰⁵

The City Auditor and Comptroller’s Office was principally responsible for compiling and updating the information in the CAFR.⁹⁰⁶ Throughout the time period covered by this Report, the City Auditor and Comptroller was Ed Ryan, and the Assistant City Auditor and Comptroller was Terri Webster.⁹⁰⁷ Within this Office, the Accounting Division managed the flow of information among the City’s individual funds, rolling up the information provided by each fund into a central database from which the CAFR was created.⁹⁰⁸ The City delegated the drafting of the Notes to the financial statements to the City’s outside auditor, which also audited the financial statements.⁹⁰⁹ The outside auditor relied on the Auditor and Comptroller’s Office and other City offices to provide it with relevant, accurate, and current information to update the Notes on an annual basis.⁹¹⁰

⁹⁰⁴ See, e.g., City of San Diego, California, Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 1997, at 134 (Nov. 21, 1997).

⁹⁰⁵ See e.g., City of San Diego, California, Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 1997, at 18-29 (Nov. 21, 1997). This explanation in the City’s CAFR of how to obtain the SDCERS stand-alone financial report is required by GASB. Governmental Accounting and Financial Reporting Standards, Vol. II, GASB 27 ¶ 20(a)(3) (June 30, 2005). However, insofar as this statement was intended to direct the reader to treat the City’s and SDCERS’s CAFRs together as integrated, this was wholly inadequate. Courts have stated that “common sense” dictates that “[a]bsent a specific declaration of incorporation, a mere mention of the annual report does not incorporate it by reference; otherwise, an annual report would automatically be incorporated by reference in any proxy statement which ever recognized the existence of, or merely accompanies, an annual report.” *Markewich v. Adikes*, 422 F.Supp 1144, 1147 (E.D.N.Y. 1976) (internal citations omitted) (holding that a proxy statement did not incorporate an annual report by reference where the proxy only mentioned the annual report).

⁹⁰⁶ City of San Diego, California, Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 2002 at v (Nov. 27, 2002).

⁹⁰⁷ Terri Webster became the Acting City Auditor and Comptroller upon Ed Ryan’s resignation in February 2004. Interview by the Audit Committee with Darlene Morrow-Truver (Apr. 26, 2006).

⁹⁰⁸ Interview by the Audit Committee with Rudy Graciano (Apr. 18, 2006).

⁹⁰⁹ Agreement between City of San Diego and Calderon, Jaham & Osborn, Certified Public Accountants (Mar. 31, 1998); Agreement between City of San Diego and Calderon, Jaham & Osborn, Certified Public Accountants (Nov. 18, 2002); Interview by the Audit Committee with Rudy Graciano (Apr. 18, 2006).

⁹¹⁰ Interview by the Audit Committee with Rudy Graciano (Apr. 18, 2006).

The retirement system issued its own Comprehensive Annual Financial Report (“SDCERS CAFR”) in about November or December of each year.⁹¹¹ This document contained introductory information about SDCERS, audited financial statements of the trust, investment allocation data, actuarial assumptions and valuations, and statistical data.⁹¹² This document was published for the purpose of providing the public with material, accurate information about the status of the retirement system.⁹¹³ Responsibility for the accuracy and fairness of the SDCERS CAFR rested with SDCERS management.⁹¹⁴

2. Bond Offering Disclosures

When the City sought to raise money from the public markets through a bond offering, it was required to release a series of disclosure documents in connection with the bond issuance. The principal disclosure documents associated with municipal bond offerings were the Preliminary Official Statement (“POS”) and the Official Statement (“OS”).⁹¹⁵ The POS was distributed to potential investors before the bonds were issued, so that the issuer and underwriter could gauge the market’s level of interest in the bonds.⁹¹⁶ The POS contained, among other things, a description of the bonds, a statement of the source of revenue with which the City would repay the bonds, and information concerning the financial health of the City, including the general-purpose financial statement portion of the City’s most recent CAFR.⁹¹⁷ The OS contained substantially the same information as the POS, but also contained pricing information.⁹¹⁸ The OS

⁹¹¹ See, e.g., San Diego City Employees’ Retirement System, Comprehensive Annual Financial Report Fiscal Year Ended June 30, 2000 (Nov. 22, 2000).

The SDCERS actuary issued an Annual Actuarial Valuation toward the beginning of each year for the previous fiscal year, setting forth the actuarial and economic assumptions for SDCERS and providing contribution information for the upcoming fiscal year. See, e.g., Gabriel, Roeder, Smith & Co., San Diego City Employees’ Retirement System Annual Actuarial Valuation June 30, 2001, at i, 4-5, 42-51 (Feb. 12, 2002). This exceeded the requirements of the Governmental Accounting Standards Board, which only requires such a report on a biennial basis.

⁹¹² See, e.g., San Diego City Employees’ Retirement System, Comprehensive Annual Financial Report Fiscal Year Ended June 30, 2000, at iv-v, 22 (Nov. 22, 2000).

⁹¹³ See, e.g., San Diego City Employees’ Retirement System, Comprehensive Annual Financial Report Fiscal Year Ended June 30, 2000, at 2, 9 (Nov. 22, 2000).

⁹¹⁴ See, e.g., San Diego City Employees’ Retirement System, Comprehensive Annual Financial Report Fiscal Year Ended June 30, 2000, at 22 (Nov. 22, 2000).

⁹¹⁵ Interview by the Audit Committee with Ed Wochaski (Apr. 20, 2006).

⁹¹⁶ Interview by the Audit Committee with Paul Webber (May 11, 2006).

⁹¹⁷ See, e.g., \$17,425,000 City of San Diego 2003 Certificates of Participation (1993 Balboa Park/Mission Bay Park Refunding) (May 29, 2003).

⁹¹⁸ See e.g., \$25,070,000 Public Facilities Financing Authority of the City of San Diego Lease Revenue Bonds Series 2002 B (Fire and Life Safety Facilities Project) (June 12, 2002). Additionally, a POS and an OS issued for the Water Utility or Sewer Utility contained sections of their respective financial statements, which were prepared and audited

was published when the issuance was finalized and was distributed to both the purchasers of the bonds and to Nationally Recognized Municipal Securities Information Repositories (“NRMSIR”), which functioned as information clearinghouses for municipal securities.⁹¹⁹ As part of the City’s continuing disclosure agreements with bond holders, it would periodically issue an Annual Report for each outstanding bond issue.⁹²⁰ The City often issued its Annual Reports in April of each year. The Annual Reports generally contained the most recent City CAFR as an attachment.

Financing Services – a division of the City Treasurer’s Office – was primarily responsible for coordinating the issuance of bond offerings and overseeing the preparation of the disclosure statements.⁹²¹ Financing Services worked with the City Attorney’s Office and several outside professionals in discharging these obligations.⁹²² An outside financial advisor provided guidance about different financing options available to the City in connection with particular financings.⁹²³ Bond counsel assisted in the preparation of the bond offering documents and with the analysis of pertinent tax-related issues.⁹²⁴ The City often engaged separate disclosure counsel to review the disclosure documents and help the City satisfy applicable securities law obligations.⁹²⁵

The POS and the OS for each bond offering contained detailed information about the purpose(s) for which funding was being sought and the terms of the securities being offered. Relevant financial information about the City appeared in two places: Appendix A to each POS and OS presented financial information about the City prepared by the Financing Services department of the City Treasurer’s

separately from the City’s CAFRs. *See, e.g.*, \$505,550,000 Public Facilities Financing Authority of the City of San Diego Subordinated Sewer Revenue Bonds, Series 2003A and Series 2003B Preliminary Official Statement, at Appendix A (“Sept. [•], 2003”); \$315,410,000 Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, Series 1999A and Series 1999B, at Appendix A (Mar. 2, 1999).

⁹¹⁹ U.S. Securities and Exchange Commission, Sources for Municipal Securities Information, *available at* <http://www.sec.gov/answers/nrmsir.htm>.

⁹²⁰ *See, e.g.*, Annual Report of the City of San Diego Relating to \$11,720,000 City of San Diego, California, Refunding Certificates of Participation (Balboa Park and Mission Bay Park Capital Improvement Program, Series 1991), Series 1996B (July 31, 1996).

⁹²¹ Interview by the Audit Committee with Lakshmi Kommi (May 4, 2006).

⁹²² Interview by the Audit Committee with Lakshmi Kommi (May 4, 2006).

⁹²³ Interview by the Audit Committee with Lakshmi Kommi (May 4, 2006).

⁹²⁴ Interview by the Audit Committee with Paul Webber (May 11, 2006).

⁹²⁵ *See, e.g.*, Letter from Orrick, Herrington & Sutcliffe LLP to City of San Diego (July 2, 1997); Letter from Hawkins, Delafield & Wood to City of San Diego (July 3, 2000); Letter from Stradling Yocca Carlson & Rauth to City of San Diego (July 1, 2002).

Office, assisted by the City Attorney's Office; and Appendix B to each POS and OS contained excerpts from the City's most recent CAFR, prepared by the City Auditor's Office.⁹²⁶

During the process of approving a bond offering resolution or ordinance, City Council members were generally provided with the applicable Preliminary Official Statement and back-up information about the offering under cover of a "Form 1472" (Request for Council Action).⁹²⁷ The Council members voted on the issuance in an open session, after the bond ordinance or resolution had been discussed at least once and a representative of Financing Services had briefed the City Council about the background of and issues relating to the bond issuance.⁹²⁸

3. Presentations to Debt Rating Agencies

Municipal bonds are analyzed by three major rating agencies: Fitch Ratings, Standard & Poor's, and Moody's Investors Service.⁹²⁹ Municipalities, such as the City of San Diego, are not required to provide information directly to rating agencies, but often do so in an attempt to explain and supplement the information contained in CAFRs and bond offering documents. The rating agencies make this information available to the investing public, and the City understands that they will do so.⁹³⁰ The agencies also use this information to rate specific offerings. The City of San Diego had annual meetings with rating agencies, and also met with them periodically to discuss particular offerings.⁹³¹ In advance of these meetings, the rating agencies provided the City with a list of questions regarding the City's finances, which the City responded to at the meetings.⁹³² These presentations covered the City's financial condition, general economic and demographic trends, and current and proposed financings.

⁹²⁶ See, e.g., \$68,425,000 Public Facilities Financing Authority of the City of San Diego, Taxable Lease Revenue Bonds, Series 1996A (San Diego Jack Murphy Stadium) (Dec. 12, 1996). Some bond offerings have this information in a different Appendix or in its own section as part of the bond. See, e.g., \$59,465,000 City of San Diego Community Facilities District No. 1 (Miramar Ranch North), Special Tax Refunding, Series 1998 (June 24, 1998); \$250,000,000 Public Facilities Financing Authority of the City of San Diego, Sewer Revenue Bonds, Series 1997A and 1997B (Feb. 1, 1997).

⁹²⁷ Interview by the Audit Committee with Brian Maienschein (May 12, 2006); Interview by the Audit Committee with Ed Wochaski (Apr. 20, 2006); Interview by Vinson & Elkins with Kelly Salt (Mar. 24, 2004).

⁹²⁸ San Diego City Charter art. III, § 16; Interview by Vinson and Elkins with Kelly Salt (Mar. 24, 2004).

⁹²⁹ WM Financial Strategies, Municipal Bond Ratings, *available at* <http://www.munibondadvisor.com/rating.htm>.

⁹³⁰ For example, following the City's Voluntary Disclosure in January 2004, several rating agencies publicly released revised outlooks on the City's financial health. See, e.g., Memorandum from Michael T. Uberuaga, City Manager, and Ed Ryan, City Auditor and Comptroller, to the Honorable Mayor and City Council (Feb. 2, 2004); Moody's Investors Service, *Moody's Changes Outlook to Negative from Stable on City of San Diego General Obligation Bonds and General Fund Obligations* (Feb. 2, 2004); see also E-mail from Paul Dyson, Standard and Poor's, to Lakshmi Kommi cc to Patricia Frazier (Feb. 23, 2004).

⁹³¹ Interview by the Audit Committee with Lakshmi Kommi (May 4, 2006).

⁹³² Interview by the Audit Committee with Lakshmi Kommi (May 4, 2006).

B. Relevant Legal Standards

While the majority of federal securities laws do not apply to municipal issuers, municipal actors – including the City’s employees, its elected officials and the City itself – are subject to the anti-fraud provisions of the securities laws, in particular Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 related thereto. These sections generally cover fraudulent acts committed in connection with the purchase or sale of a security, which would include any acts committed in connection with the offering or sale of municipal bonds issued by the City of San Diego. More particularly, Section 10(b) and Rule 10b-5 broadly “prohibit any person, including municipal issuers and brokers, dealers and municipal securities dealers, from making a false or misleading statement of material fact, or omitting any material facts necessary to make statements made by that person not misleading, in connection with the offer, purchase or sale of any security.”⁹³³ This provision applies to a primary violator – a person or entity “who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies . . . assuming *all* of the requirements for primary liability under Rule 10b-5 are met” – and to one who aids and abets such a violation.⁹³⁴

In order to establish a violation of Section 10(b) and Rule 10b-5, there must be proof: (a) of a false or misleading statement or omission; (b) of the materiality of the statement or omission; (c) that the statement or omission was made in connection with the purchase or sale of a security; and (d) that the statement or omission was made with “scienter,” or intent, which in the securities context means “a mental state embracing intent to deceive, manipulate or defraud.”⁹³⁵ Scienter can also include reckless, and not just intentional, conduct, as long as it is “highly unreasonable . . . , involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.”⁹³⁶ In addition, a statement or omission is material “if there is a substantial likelihood that a reasonable shareholder would consider it important” or that “the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of

⁹³³ U.S. Securities and Exchange Commission, Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others, Securities Act Release No. 7049, 56 SEC Docket 479, 1994 WL 73628, at *4 (Mar. 9, 1994).

⁹³⁴ *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191 (1994) (emphasis in original), *superseded by statute on other grounds*, 15 U.S.C. § 78t(f) (West 2006). While *Central Bank of Denver* eliminated private causes of action for aiding and abetting securities act violations, § 20(e) of the Securities Exchange Act permits such actions to be brought by the SEC. 15 U.S.C. § 78t(e) (West 2006).

⁹³⁵ *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976).

⁹³⁶ *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569 (9th Cir. 1990).

information made available.”⁹³⁷ Materiality “depends on the significance the reasonable investor would place on the withheld or misrepresented information.”⁹³⁸

Section 17(a) has the same elements as Section 10(b) and Rule 10b-5 for establishing a securities law violation, except for the final element of intent. Sections 17(a)(2) and 17(a)(3) require only proof of negligence for statements made in connection with the issuance of securities.⁹³⁹

The SEC has sought and entered cease-and-desist orders and, on occasion, injunctions, against both municipal issuers and municipal officials on the basis of Section 10(b), Rule 10b-5, and Section 17(a). One such enforcement action involved Orange County, California, which had not disclosed in several bond offering disclosure statements that most of the County’s assets were invested in high-risk investment pools upon which the County relied significantly for balancing its budget and repaying bond debt. The SEC charged Orange County with securities fraud and entered a cease-and-desist order against it for violations of Section 10(b), Rule 10b-5, and Section 17(a).⁹⁴⁰ The SEC also sought and obtained permanent injunctions against Orange County’s Treasurer and Assistant Treasurer based on a finding that these high-level officials understood the overall danger involved with tying a high-risk investment strategy to the ability of the County to meet its current and future financial obligations.⁹⁴¹

In a similar case several years later, the SEC entered a cease-and-desist order against the City of Miami for issuing misleading disclosure statements in connection with three bond offerings and Miami’s 1994 financial statement.⁹⁴² Like San Diego, Miami failed adequately to disclose information about a looming financial crisis about which it had been warned and downplayed concerns about its practice of informally shifting money between various City funds to pay off a growing budget deficit. The SEC also

⁹³⁷ *TSC Industries, Inc. v. Northway, Inc.*, 426 US 438, 449 (1976).

⁹³⁸ *Basic, Inc. v. Levinson*, 485 U.S. 224, 240 (1988).

⁹³⁹ *Aaron v. SEC*, 446 U.S. 680, 697 (1980). Section 17(a)(1), which makes it unlawful for an individual to employ any device, scheme, or artifice to defraud, does require proof of intent. *Id.* Section 17(a)(2) makes it unlawful for an individual to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading. Section 17(a)(3) makes it unlawful for an individual to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser. 15 U.S.C. § 77q(a) (West 2006).

⁹⁴⁰ *In re County of Orange, California*, Securities Act Release No. 7260, 61 SEC Docket 310, 1996 WL 34362, at *1 (Jan. 24, 1996).

⁹⁴¹ *SEC v. Robert L. Citron and Matthew R. Raabe*, Litigation Release No. 14,913, 61 SEC Docket 2510, 1996 WL 276758, at *1 (May 17, 1996).

⁹⁴² *In re City of Miami, Florida, Cesar Odio and Manohar Surana*, 75 SEC Docket 725, 2001 WL 715493, at *27 (June 22, 2001), *aff’d*, *In re City of Miami, Florida*, Securities Act Release No. 8213, 79 SEC Docket 2580, 2003 WL 1412636, at *11 (Mar. 21, 2003).

entered cease-and-desist orders under Section 10(b), Rule 10b-5, and Section 17(a) against Miami's City Manager and Assistant City Manager for their substantial roles in issuing the misleading disclosure statements.⁹⁴³

While the Orange County and Miami enforcement actions involved findings that City officials acted with scienter in violating the antifraud provisions of the federal securities laws, the SEC has also proceeded against municipal issuers on the basis of the negligence standard of Section 17(a)(2) and (3) of the Securities Act. Most recently, the SEC entered a cease-and-desist order against the Massachusetts Turnpike Authority ("MTA") and its chairman for failing to disclose projected cost increases in a tunnel construction project to those officials preparing and approving three bond offerings.⁹⁴⁴ The SEC concluded that the MTA and its chairman acted negligently in connection with the bond offerings in that they should have appreciated the significance to investors of the almost-certain budget increase, thus committing and causing violations of Section 17(a)(2) and (3).⁹⁴⁵

⁹⁴³ *In re of Cesar Odio*, Securities Act Release No. 7851, 72 SEC Docket 501, 2000 WL 378031, at *5 (Apr. 14, 2000); *In re Manohar Surana*, Securities Act Release No. 7895, 73 SEC Docket 869, 2000 WL 1364414, at *4 (Sept. 22, 2000).

⁹⁴⁴ *In re Massachusetts Turnpike Authority and James E. Kerasiotes*, Securities Act Release No. 8260, 80 SEC Docket 2081, 2003 WL 21757219, at *1 (July 31, 2003).

⁹⁴⁵ In addition to the matters discussed above, the SEC has successfully pursued numerous other securities fraud enforcement actions against municipal issuers and officials in the recent past. *See, e.g., In re Dauphin County General Authority*, Securities Act Release No. 8415, 2004 SEC LEXIS 886, at *9 (Apr. 26, 2004) (entering cease-and-desist order against municipal issuer for disclosure violations in connection with a bond offering, noting that "[e]xecuting offering documents without first reading the documents to ascertain whether they were accurate may be reckless"); *In re Coahoma County*, Securities Act Release No. 7554, 67 SEC Docket 1121, 1998 WL 385503, at *5 (July 13, 1998) (entering cease-and-desist orders against 38 municipal issuers for disclosure violations in connection with numerous bond offerings prepared by the same bond counsel and underwriter, emphasizing that "[i]ssuers may not blindly rely on professionals such as bond counsel, to ensure that factual representations being made by the issuers are accurate"); *In re County of Nevada, City of Ione, Wasco Public Financing Authority, Virginia Horler, and William McKay*, Securities Act Release No. 7537, 67 SEC Docket 160, 1998 WL 217144, at *3 (May 5, 1998) (entering cease-and-desist order against municipal issuer for disclosure violations in connection with two bond offerings, noting that "[e]ven though it retained and relied upon professional financial and legal advisers and appraisers, Ione was responsible under Sections 17(a)(2) and 17(a)(3) for any misrepresentations and/or omissions in the CFD-1 and CFD-2 Official Statements"); *In re City of Syracuse, New York, Warren D. Simpson, and Edward D. Polgreen*, Securities Act Release No. 7460, 65 SEC Docket 1199, 1997 WL 598008, at *7 (Sept. 30, 1997) (entering cease-and-desist order against municipal issuer and officials for disclosure violations in connection with two bond offerings, finding that City officials "knew, or were reckless in not knowing," about problems with the financial information referenced in the offering statements and that certain tax accounting did not conform with GAAP); *In re Maricopa County*, Securities Act Release No. 7354, 62 SEC Docket 2574, 1996 WL 562168 (Oct. 3, 1996), at *2 (entering cease-and-desist order against municipal issuer for disclosure violations in connection with several bond offerings, finding that the issuer used stale financial information in the offering statements and mislead investors as to the purpose of the bond issuances).

C. Governmental Accounting Standards Board Statements and Other Applicable Accounting Standards

While the federal securities law anti-fraud provisions serve as the foundation for potential liability, municipal issuers are also regulated on a more continuing basis by financial statement disclosure standards set by both the federal government and accounting standards organizations. As the SEC has emphasized:

Sound financial statements are critical to the integrity of the primary and secondary markets for municipal securities, just as they are for corporate securities. The key to the reliability and relevancy of the information contained in the financial statements of a municipal issuer is the use of a comprehensive body of accounting principles consistently applied by the issuer.⁹⁴⁶

The City represents in its CAFRs that it conforms its financial accounting policies to generally accepted accounting principles in the United States (“GAAP”).⁹⁴⁷ The Governmental Accounting Standards Board – as recognized by the American Institute of Certified Public Accountants (“AICPA”) and the Government Finance Officers Association (“GFOA”) – is the ultimate authority in setting the standards for GAAP for state and local governments.⁹⁴⁸

Further, as a recipient of federal grants, the City must undergo a yearly audit, pursuant to the Single Audit Act,⁹⁴⁹ through which it must satisfy, among other things, the standards prescribed by the United States Office of Management and Budget for state and local governments. To comply with federal requirements, the City’s outside auditor conducts an annual audit and prepares a Single Audit Report, in addition to and separate from the City’s Comprehensive Annual Financial Report.⁹⁵⁰ The Single Audit Report – circulated to agencies overseeing the City’s compliance with its receipt of federal grants – must be prepared pursuant to generally accepted government auditing standards, including those embodied in “circulars” set forth by the Office of Management and Budget and in *Government Auditing Standards* (also known as the “Yellowbook”) issued by the United States Government Accountability Office.⁹⁵¹

⁹⁴⁶ Securities and Exchange Commission, Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others, Securities Act Release No. 7049, 56 SEC Docket 479, 1994 WL 73628, at *8 (Mar. 9, 1994).

⁹⁴⁷ See, e.g., City of San Diego, California, Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 2002, at 27-1 (Nov. 27, 2002).

⁹⁴⁸ AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, AICPA AUDIT AND ACCOUNTING GUIDE: STATE AND LOCAL GOVERNMENTS 83,023 (2005).

⁹⁴⁹ 31 U.S.C. §§ 7501-7507 (West 2006).

⁹⁵⁰ City of San Diego, California, Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 2002, at v-vi (Nov. 27, 2002).

⁹⁵¹ 31 U.S.C. § 7502(c) (West 2006).

These accounting principles and financial reporting requirements, in addition to other SEC pronouncements, provide a relevant baseline for understanding the disclosure required for a state or local governmental entity. A brief analysis of these standards is relevant to the ultimate determination of whether a misrepresentation or omission of fact is material and, thus, whether a municipality has satisfied its legal disclosure obligations.

1. **Governmental Accounting Standards Board Statements**

The GASB establishes standards for accounting and financial reporting by state and local governments, including specific guidance for public employee retirement systems. Statements and interpretations put forth by the GASB serve as the most authoritative source of GAAP standards, though other bulletins and information put forth by the GASB and the AICPA also provide relevant guidance for municipalities.⁹⁵²

A brief description of some of the GASB Statements applicable to the City and SDCERS is provided below.

- *GASB 10.* Under GASB 10, disclosure of a contingency should be made when there is a reasonable possibility that a loss may have been incurred.⁹⁵³ The disclosure should identify the nature of the contingency and provide an estimate or range of the possible loss (or state that such an estimate cannot be made).⁹⁵⁴ If an asset is impaired or a liability is incurred subsequent to the effective date of the entity's financial statements (but before their issuance) this also must be disclosed to prevent the financial statement from being misleading.⁹⁵⁵
- *GASB 12.* GASB 12 addresses disclosure of information regarding post-employment, non-pension benefits, also known as "other

⁹⁵² American Institute of Certified Public Accountants, AICPA Professional Standards, Vol. 1, AU § 411.18 (June 1, 2005).

⁹⁵³ A loss must be disclosed under GASB 10 § 58 if no accrual is made for a loss contingency because one or both of the conditions in GASB 10 § 53 are met, or if an exposure to loss exists in excess of the amount accrued in accordance with the provisions of paragraph 53. Paragraph 53 conditions are:

- a. Information available before the financial statements are issued indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be probable that one or more future events will also occur confirming the facts of the loss.
- b. The amount of loss can be reasonably estimated.

⁹⁵⁴ Governmental Accounting and Financial Reporting Standards, Vol. II, GASB 10 § 58 (June 30, 2005).

⁹⁵⁵ Governmental Accounting and Financial Reporting Standards, Vol. II, GASB 10 § 80 (June 30, 2005).

post-employment benefits.⁹⁵⁶ Post-retirement healthcare benefits are an example of such a benefit. An employer that provides such benefits must disclose a description of the benefit provided, eligibility requirements, and a quantification of both the employer and participant contribution obligations.⁹⁵⁷ Additionally, the employer must provide a description of the accounting and financing or funding policies followed, and any additional information that the employer believes will help users assess the nature and magnitude of the costs of the employer's financial commitment to the other post-employment benefits.⁹⁵⁸

- *GASB 25.* GASB 25 provides standards to enhance the understandability and usefulness of pension information included in the financial statements of state and local government pension plans. For defined benefit pension plans, the financial statements should provide information about (a) plan assets, plan liabilities, and plan net assets; (b) the year-to-year changes in plan net assets; (c) the funded status of the plan over the long term and the progress made in accumulating sufficient assets to pay benefits when due; and (d) the contribution requirements of plan members, employers, and other contributors and the extent of compliance with those requirements.⁹⁵⁹
- *GASB 26.* GASB 26 applies to post-employment healthcare plans administered by state and local governmental defined benefit pension plans.⁹⁶⁰ When post-employment healthcare is administered by a defined benefit pension plan, the plan's financial report must include:
 - (a) a *statement of postemployment healthcare plan net assets*,
 - (b) a *statement of changes in postemployment healthcare plan net assets*, and (c) notes to the financial statements, all prepared in accordance with the pension plan reporting standards. The notes also should include a brief

⁹⁵⁶ Other post-employment benefits ("OPEB") are "post-employment benefits provided by an employer to plan participants, beneficiaries, and covered dependents through a plan or other arrangement that is *separate* from a plan to provide retirement income. However, for purposes of the Statement, OPEB also include post-employment health care benefits provided through a PERS or pension plan." Governmental Accounting and Financial Reporting Standards, Vol. II, GASB 12 ¶ 3 (June 30, 2005) (emphasis in original).

⁹⁵⁷ Governmental Accounting and Financial Reporting Standards, Vol. II, GASB 12 ¶ 10(a) (June 30, 2005).

⁹⁵⁸ Governmental Accounting and Financial Reporting Standards, Vol. II, GASB 12 ¶ 10(c) (June 30, 2005).

⁹⁵⁹ Governmental Accounting and Financial Reporting Standards, Vol. II, GASB 25 ¶ 7 (June 30, 2005). The City and SDCERS adopted GASB 25 beginning July 1, 1996. San Diego, California, Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 1997 at 1 (Nov. 21, 1997); San Diego Employees' Retirement System, Comprehensive Annual Financial Report, Fiscal Year Ended June 30, 1997 and 1996, at 40 (Feb. 20 1998).

⁹⁶⁰ GASB 26, an Interim Statement, is effective for reporting periods beginning after June 15, 1996. Governmental Accounting and Financial Reporting Standards, Vol. II, GASB 26 ¶ 10 (June 30, 2005). Beginning in FY 2008, San Diego's disclosure obligations related to its post-retirement healthcare plan will be regulated by GASB 45.

description of the eligibility requirements for postemployment healthcare benefits and the required contribution rate(s) of the employer(s).⁹⁶¹

- *GASB 27.* GASB 27 sets out standards for the measurement of pension expenditures and related liabilities, assets, note disclosures, and required supplementary information in the financial reports of state and local governmental employers. In the notes to its financial statements, an employer should include a brief description of the types of benefits and the authority establishing each benefit for its plan.⁹⁶²
- *GASB 34.*⁹⁶³ GASB 34 addresses basic financial statements and the section of financial reports directed to management's discussion and analysis for state and local governments. A governmental entity should describe "currently known facts, decisions, or conditions that are expected to have a significant effect on financial position (net assets) or results of operations (revenues, expenses, and other changes in net assets)."⁹⁶⁴

2. SEC Staff Accounting Bulletin No. 99: Materiality

The materiality of misstatements in financial statements is discussed in SEC Staff Accounting Bulletin No. 99 ("SAB 99"). According to SAB 99, "[t]he omission or misstatement of an item in a financial report is material if, in the light of the surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item."⁹⁶⁵ Misstatements are not immaterial simply because they fall beneath a quantitative threshold. A misstatement of even a relatively small amount could have a material effect on a financial statement.⁹⁶⁶

3. Office of Management and Budget Circular No. A-133

Office of Management and Budget Circular No. A-133 addresses the obligation of a recipient of federal grant funds to comply with laws, regulations, and contractual or grant agreements, since

⁹⁶¹ Governmental Accounting and Financial Reporting Standards, Vol. II, GASB 26 ¶ 7 (June 30, 2005) (emphasis in original).

⁹⁶² The City adopted GASB 27 in its CAFR for the fiscal year ending on June 30, 1997. City of San Diego, California, Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 1997, at 1 (Nov. 21, 1997).

⁹⁶³ The City adopted GASB 34 in its CAFR for the fiscal year ending on June 30, 2002. City of San Diego, California, Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 2002, at 2 (Nov. 27, 2002).

⁹⁶⁴ Governmental Accounting and Financial Reporting Standards, Vol. II, GASB 34 ¶ 11(h) (June 30, 2005).

⁹⁶⁵ SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45150, 45151 (Aug. 19, 1999).

⁹⁶⁶ SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45150, 45152 (Aug. 19, 1999).

failure to comply with such requirements could have a material effect on the federal program.⁹⁶⁷ An entity that receives federal funds must have those funds audited annually, and the audit must be filed in most cases within 9 months.⁹⁶⁸ If the audit results in a finding of a material noncompliance, a statement to that effect must be made.⁹⁶⁹ The City has not completed an audit of its federal grant funds since 2002.⁹⁷⁰

D. Pension Disclosure Deficiencies

From the time that MP-1 was adopted in June 1996, through January 2004, when the City made a corrective voluntary disclosure, the City's various disclosure documents omitted or presented in an inaccurate or misleading fashion material information concerning the City's pension funding arrangement and its potential impact on the City's financial health. The disclosure deficiencies, ranging in importance from critical to mundane, are detailed in Appendix L to this Report. What follows is a brief summary of the more significant deficiencies affecting the City's pension disclosure.

In the discussion that follows, we consider each category of disclosure document previously described for the six major disclosure deficiencies we have identified: (1) MP-1; (2) the *Corbett* litigation and settlement; (3) the MP-1 funding trigger and the City's financial crisis; (4) MP-2; (5) post-retirement healthcare liability, and (6) the City's net pension obligation.

1. Disclosure Failures Related to the Terms of MP-1

As noted above, MP-1 was adopted on June 21, 1996.⁹⁷¹ Despite the significance of MP-1, both in terms of the risks inherent in underfunding the City's pension system and the City's decision to abandon accepted actuarial principles in calculating its pension contribution obligations, the City did not disclose anything about MP-1 in either its CAFR or any other publicly-filed financial document until its 1998 CAFR (filed on November 25, 1998).⁹⁷² In the interim, the City's 1997 CAFR, which was issued in late 1997 and was the first CAFR that should have incorporated the changes implemented with MP-1, contained the following disclosure with respect to the City's pension obligations:

⁹⁶⁷ Office of Mgmt. & Budget, Circular No. A-133 §§ A.100, B.225 (June 27, 2003).

⁹⁶⁸ Office of Mgmt. & Budget, Circular No. A-133 §§ B.220, B.235(c) (June 27, 2003).

⁹⁶⁹ Office of Mgmt. & Budget, Circular No. A-133 §§ B.320(b)(2)(iii) (June 27, 2003).

⁹⁷⁰ While the City has met this requirement since 2002, it apparently has been granted an extension of time within which to satisfy this requirement.

⁹⁷¹ Minutes, SDCERS Board Meeting at 31 (June 21, 1996).

⁹⁷² City of San Diego, California, Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 1998 at VII (Nov. 25, 1998).

*SDCERS' funding policy provides for periodic employer contributions at actuarially determined rates that, expressed as percentages of annual covered payroll, are designed to accumulate sufficient assets to pay benefits when due. The normal cost and actuarial accrued liability are determined using the projected unit credit actuarial funding method. Unfunded actuarial accrued liabilities are being amortized as a level percent of payroll over a period of 30 years (25 years remaining) . . . The City and the District contribute a portion of the employees' share and the remaining amount necessary to fund the system based on an actuarial valuation at the end of the preceding year under the projected unit credit method of actuarial valuation*⁹⁷³

This disclosure was inaccurate because MP-1 changed the City's pension funding policy. Under MP-1, the City and the SDCERS Board agreed the City would be permitted to contribute to SDCERS in an amount less than what would have been required had actuarially determined rates been used.⁹⁷⁴ The City, however, falsely claimed that it continued to contribute to SDCERS at actuarially determined rates when, in fact, it did not. This statement remained substantially unchanged in the City's CAFRs for fiscal years 1997 through 2002.

It was not until late 1998 – more than two years after the adoption of MP-1 – that the City first disclosed the existence of MP-1 in a footnote to its CAFR for fiscal year 1998. Even then, the disclosure was insufficient in numerous respects:

In 1996 the City Council approved proposed changes to [SDCERS] which included changes to retiree health insurance, plan benefits, employer contribution rates and system reserves. The proposal included a provision to assure the funding level of the system would not drop below a level the Board's actuary deems reasonable in order to protect the financial integrity of the SDCERS. . . . The San Diego Municipal Code was then amended to reflect the changes. The changes provide the employer contribution rates be "ramped up" to the actuarially recommended rate in .50 percent increments over a ten year period at such time it was projected that the Projected Unit Credit

⁹⁷³ City of San Diego, California, Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 1997, at 18-29 (Nov. 21, 1997) (emphasis added).

⁹⁷⁴ Regarding the 1997 City CAFR, the 2004 V&E Report found that "not only did the relevant section of the 1997 CAFR fail to mention the significant changes to the funding policy resulting from MP-1, it described that policy in terms that were inaccurate for that fiscal year." Paul S. Maco & Richard C. Sauer, Vinson & Elkins LLP, Report on Investigation, The City of San Diego, California's Disclosures of Obligation to Fund the San Diego Employees Retirement System and Related Disclosure Practices 1996–2004 with Recommended Procedures and Changes to the Municipal Code at 63 (Sept. 16, 2004). This Report concluded that the description of City contributions and the lack of a reported NPO in the 1997 City CAFR was "at best, incomplete and misleading." *Id.* at 183. In its 2005 Report, Vinson & Elkins concluded that "there is sufficient Available Evidence to support the conclusion that the City's disclosure was materially deficient as a result of its failure to meaningfully describe the risks embodied in its unorthodox system on pension funding." Paul S. Maco & Richard C. Sauer, Vinson & Elkins LLP, Potential Violations of the Federal Securities Laws by the City of San Diego and Associated Individuals at 36 (Draft July 15, 2005). Vinson & Elkins reached this conclusion on the basis of the City's disclosures from 1997 to 2003, but did not separately address in its 2005 Report the omission in the 1997 City CAFR of any mention of the MP-1 funding arrangement. *Id.* at 31.

(PUC) and Entry Age Normal (EAN) rates would be equal and the SDCERS would convert to EAN. The actuary calculated the present value of the difference between the employer contribution rate and actuarial rates over the ten-year period and this amount was funded in a reserve. This “Corridor” funding method is unique to the SDCERS and therefore is not one of the six funding methods formally sanctioned by the [GASB] for expending purposes. As a result for June 30, 1998, the actuary rates are reported to be \$5,975,000 more than paid by the City which, technically per GASB 27 . . . is to be reported as a [NPO] even though the shortfall is funded in a reserve. *The actuary believes the Corridor funding method is an excellent method for the City and that it will be superior to the PUC funding method. The actuary is in the process of requesting the GASB to adopt the Corridor funding method as an approved expending method which would then eliminate any reported NPO.*⁹⁷⁵

The City’s disclosure omitted several key components of the MP-1 agreement.⁹⁷⁶ The disclosure noted that the agreement implemented changes in benefits and employer contributions, but it did not disclose that employer contribution rates were set at rates lower than actuarially required, in violation of a condition required by the City Charter,⁹⁷⁷ nor did it disclose what additional benefits were granted.⁹⁷⁸ It also failed to disclose that the benefit enhancements granted in MP-1 were contingent upon the SDCERS Board approving contribution relief for the City, estimated at the time to be a reduction in funding payments of approximately \$110 million through the end of the agreement.⁹⁷⁹

⁹⁷⁵ City of San Diego, California, Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 1998 at 20-29 (Nov. 25, 1998) (emphasis added).

⁹⁷⁶ Vinson & Elkins found that the description of MP-1 in the City’s 1998 CAFR was “inaccurate from the outset - and became increasingly misleading as actual events diverged from hopes, guesses and actuarial projections.” Paul S. Maco & Richard C. Sauer, Vinson & Elkins LLP, Report on Investigation, The City of San Diego, California’s Disclosures of Obligation to Fund the San Diego Employees Retirement System and Related Disclosure Practices 1996-2004 with Recommended Procedures and Changes to the Municipal Code at 67 (Sept. 16, 2004). Specifically, Vinson & Elkins found that the City’s 1998 CAFR did not explain that MP-1 was a form of contribution relief obtained by the City in exchange for benefit enhancements, or that earnings were being diverted for uses other than the long-term financial strength of the system. In addition, Vinson & Elkins found that the statement that the NPO was funded in a reserve, as well as the description of the “trigger,” would lead a reader to an incorrect understanding of these issues. *Id.* at 65-67. Despite these findings, Vinson & Elkins concluded that “there is no evidence to suggest that the language was drafted to mislead,” and that “both SDCERS and City staff, as well as various attorneys and auditors, were genuinely confused about the operation of the reserves that would supposedly offset the contribution shortfalls from MP1 - and remained confused for years to come.” *Id.* at 67.

⁹⁷⁷ San Diego City Charter art. IX, § 143 (amended 2002).

⁹⁷⁸ This omission violated GASB 27, which requires the City to disclose factors that significantly affect the identification of trends in amounts reported. Governmental Accounting and Financial Reporting Standards, Vol. II, GASB 27 ¶ 22(b) (June 30, 2005). Changes in benefit provisions would be one such factor.

⁹⁷⁹ Memorandum from Cathy Lexin, Labor Relations Manager, to Larry Grissom, Retirement Administrator (July 23, 1996).

Moreover, the disclosure failed to discuss the effect of the trigger and the fact that, if the SDCERS funded ratio declined below the trigger, the City would have to make a large lump-sum payment to SDCERS – or begin contributing at a substantially higher rate – and that either outcome posed a potential risk to the City’s future financial health. The indirect reference to the trigger (“a provision to assure the funding level would not drop below a level the Board’s actuary deems reasonable”) was insufficient to describe the risk to the City if the funded level fell below the trigger.⁹⁸⁰

The description of the funding method was likewise misleading. It stated, “the Corridor funding method is an excellent method . . . it will be superior to the PUC funding method. The actuary is in the process of requesting the GASB to adopt the Corridor funding method as an approved expending method which would then eliminate any reported NPO.”⁹⁸¹ The City’s disclosure suggested that its funding method was no more than a technical accounting matter that would be resolved as soon as the GASB adopted “Corridor” funding as an approved method. In fact, there was no certainty that such a thing would ever happen and, as it turned out, it never did.

The City also failed to disclose the possibility that MP-1 could be found to be illegal if challenged in court. Although the City stated that “the San Diego Municipal Code was then amended to reflect the changes” initiated by MP-1,⁹⁸² this statement was inaccurate: the City never amended the Municipal Code to accommodate MP-1. Moreover, the City did not disclose that because of MP-1 its contributions to the pension system were not in compliance with either the City Charter or the Municipal Code, which required contributions at actuarially determined rates, and that the City’s failure to contribute to SDCERS at actuarially determined rates could subject it to future liability to SDCERS or cause the entire MP-1 arrangement to be voided – another potential risk to the City’s future financial health.

Finally, the City failed to disclose the conflicts of interest of SDCERS Board members, most of whom were, at that time, also City employees, voting on a proposal that provided contribution relief to the City in exchange for enhanced benefits that would accrue to them personally.⁹⁸³

⁹⁸⁰ These deficiencies are a violation of GASB 27, which requires the City to disclose, among other things, factors that significantly affect the identification of trends in the amounts reported, including changes in the actuarial methods and assumptions used. Governmental Accounting and Financial Reporting Standards, Vol. II, GASB 27 ¶ 22(b) (June 30, 2005).

⁹⁸¹ City of San Diego, California, Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 1998, at 20-29 (Nov. 25, 1998).

⁹⁸² City of San Diego, California, Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 1998, at 20-29 (Nov. 25, 1998).

⁹⁸³ At the time that MP-1 was approved by the SDCERS Board, the following individuals were City employees who were serving as SDCERS Board members: Bruce Herring, Deputy City Manager; Terri Webster, Assistant City Auditor and Comptroller; Conny Jamison, City Treasurer; John Casey, City Planning & Development; John Torres, Forensics, San Diego Police Department; and Sharon Wilkinson, Qualcomm Stadium. Terri Webster, Bruce Herring, Sharon Wilkinson, Robert Scannell, Keith Enerson, Ron Saathoff, John Torres, and Conny Jamison voted

The City's disclosure in its 1998 CAFR about MP-1 generally remained the same from year to year after 1998. It violated the specific disclosure standards in GASB Statement No. 27, *Accounting for Pensions by State and Local Government Employers*, which governed the City's disclosures in 1997 and subsequent years, because it failed to disclose (i) the changes in retirement benefits, (ii) that City contribution rates were less than actuarially required, (iii) the trigger threshold of 82.3%, and (iv) the potential financial implications to the City of breaching the trigger threshold, among other things. Despite the specific requirements of GASB 27, these matters were either inaccurately disclosed or only partially disclosed in the City CAFRs from 1997 through 2002.

None of the disclosure deficiencies in the City's CAFR were corrected in the corresponding SDCERS CAFR, if anyone had thought to look there for more detailed or accurate information. For fiscal years 1997 through 2002, the SDCERS CAFR repeated the following false and misleading statements about the system's pension funding mechanism:

SDCERS' funding policy provides for periodic employer contributions *at actuarially determined rates* that, expressed as percentages of annual covered payroll, are designed to accumulate sufficient assets to pay benefits when due. . . .

The City and the District contribute a portion of the employees' share and the remaining amount necessary to fund the system *based on an actuarial valuation at the end of the preceding year under the projected unit credit method of actuarial valuation*. . . .⁹⁸⁴

The statements in the SDCERS CAFR throughout this period that the City's payments were "actuarially determined" or "based on an actuarial valuation" were simply false.

Finally, the City's disclosures in connection with bond offerings during the relevant time period were similarly deficient with respect to MP-1.⁹⁸⁵ From 1996 through 2003, while MP-1 came and

to approve MP-1. Jack Katz, Ann Parode, and Paul Barnett opposed MP-1. Minutes, SDCERS Board Meeting at 31 (June 21, 1996).

⁹⁸⁴ San Diego City Employees' Retirement System, Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 1999, at 22 (Aug. 31, 2000); San Diego Employees' Retirement System, Comprehensive Annual Financial Report for Fiscal Years Ended June 30, 1997 and 1996, at 48 (Feb. 20, 1998). The language in subsequent SDCERS CAFRs through FY 2002 remained substantially unchanged. There were also additional deficiencies in subsequent CAFRs. For example, in the SDCERS 1999 CAFR, a brief description of MP-1 was included, but in the incorrect footnote, in the *Schedule of Employer Contributions* (at the end of the footnotes section) rather than in the section for *Contributions Required and Contributions Made*. San Diego City Employees' Retirement System, Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 1999, at 22-23, 31 (Aug. 31, 2000). This disclosure lacked a description of benefit changes made, a statement that City contributions were less than actuarially determined rates, a discussion about the contingent nature of the overall agreement, and the implications of hitting the 82.3% funded ratio trigger. The failure to disclose these key components of the MP-1 agreement did not comply with GASB 25.

⁹⁸⁵ In its 2005 Report, Vinson & Elkins found that Appendix A to the City's bond offering documents during this time period included "boilerplate" language, without meaningful review. Paul S. Maco & Richard C. Sauer, Vinson &

went and MP-2 was adopted, the City's discussion of SDCERS in the Pension Plan note to the bond offering remained essentially unchanged. It said (in 1996):

Pension Plan

All City full-time employees participate with the full-time employees of the San Diego Unified Port District in the City Employees' Retirement System ("CERS"). CERS is a multiple-employer public employee retirement system that acts as a common investment and administrative agent for the City and the District. Through various benefit plans, CERS provides retirement benefits to all general and safety (police and fire) members. The CERS plans are structured as defined benefit plans in which benefits are based on salary, length of service and age. City employees are required to contribute a percentage of their annual salary to CERS. *State legislation requires the City to contribute to CERS at rates determined by actuarial valuations.*

The City's last annual valuation dated June 30, 1995 stated that the funding ratio (Net Assets available for Benefits to Pension Benefit Obligation) of the SDCERS fund to be 86.8%. However, as there are some on-going meet and confer items being discussed, the Actuarial Report has not been ratified by the Retirement Board but is expected to be ratified in the near future. The CERS fund has an Unfunded Actuarial Accrued Liability (UAAL) of \$96.3 million as of June 30, 1995. The UAAL is the difference between total actuarial accrued liabilities of \$1.477 billion and assets allocated to funding of \$1.380 billion. The UAAL is amortized over a 30 year period which started July 1, 1991, with each year's amortization payment reflected as a portion of the percentage of payroll representing the employer's contribution rate. As of June 30, 1995, there were 26 years remaining in the amortization period.⁹⁸⁶

With the exception of certain financial information, such as the funded ratio and UAAL which changed over time, the above statement remained essentially the same from 1996 through the last bond offering by the City in 2003.⁹⁸⁷

Elkins LLP, Potential Violations of the Federal Securities Laws by the City of San Diego and Associated Individuals at 38 (Draft July 15, 2005). However, V&E noted, in mitigation, that the City's bond offering documents also contained the City's financial statements "which disclosed, however imperfectly, that the City had entered into a 'corridor funding' arrangement" with SDCERS. *Id.*

⁹⁸⁶ Public Facilities Financing Authority of the City of San Diego, Taxable Lease Revenue Bonds, Series 1996A (San Diego Jack Murphy Stadium), \$68,425,000 at A-30 to A-31 (Dec. 12, 1996) (emphasis added).

⁹⁸⁷ "All benefited City employees participate with the full-time employees of the San Diego Unified Port District (the "District") in the City Employees' Retirement System ("CERS"). CERS is a public employee retirement system that acts as a common investment and administrative agent for the City and the District. Through various benefit plans, CERS provides retirement benefits to all general, safety (police and fire), and legislative members.

The CERS plans are structured as defined benefit plans in which benefits are based on salary, length of service, and age. City employees are required to contribute a percentage of their annual salary to CERS. State legislation requires the City to contribute to CERS at rates determined by actuarial valuations.

Throughout this time, the City's description of its pension plan in its Preliminary Official Statements and Official Statements was misleading. The statement that "State legislation requires the City to contribute to CERS at rates determined by actuarial valuation," while literally true,⁹⁸⁸ failed to disclose that the City was not, in fact, contributing to SDCERS at actuarially calculated rates due to the contribution relief afforded by MP-1 and, later, MP-2.⁹⁸⁹

The fact that the City and SDCERS had entered into MP-1, the nature of this agreement, and its potential implications for the funded level of SDCERS, were material information that should have been disclosed. This funding mechanism implicated the primary concern of a bondholder – the ability of the issuer to pay its debts as they come due. Although SDCERS's funded ratio was more than 90% when MP-1 was adopted, by fixing the City's contributions, MP-1 virtually ensured an eroded funded ratio and a higher UAAL in the future. A higher UAAL would require the City, once it returned to actuarially-driven contributions, to make significantly increased payments to the pension system in future years. If the City were ultimately unable to make all of its legally-required payments, it may have had no choice but to default on its bond obligations. The City's intentional underfunding of its pension system would therefore have been an important factor to a reasonable investor considering whether to purchase the City's bonds.⁹⁹⁰

The City's last actuarial valuation dated June 30, 2002, stated the funding ratio (Valuation of Assets available for Benefits to Total Actuarial Accrued Liability), of the CERS fund to be 77.3%. The CERS fund has an Unfunded Actuarial Accrued Liability (UAAL) of \$720.7 million as of June 30, 2002, which represents a \$436.8 million increase in the UAAL since the previous actuarial calculation dated June 30, 2001. The UAAL is the difference between the total actuarial accrued liabilities of \$3.169 billion and assets allocated to funding of \$2.448 billion. The increase in the UAAL as of June 30, 2002, results primarily from investment losses. The UAAL is amortized over a 30-year period, which started July 1, 1991, with each year's amortization payment reflected as a portion of the percentage of payroll representing the employer's contribution rate. As of June 30, 2002, there were 19 years remaining in the amortization period."

City of San Diego, California, 2003-2004 Tax Anticipation Notes, Series A, \$110,900,000 at A-32 (July 1, 2003).

⁹⁸⁸ Cal. Gov't Code § 45342 (2006). *See, e.g.*, City of San Diego, California, 2003-2004 Tax Anticipation Notes, Series A, \$110,900,000 at A-32 (July 1, 2003).

⁹⁸⁹ *See, e.g.*, City of San Diego, California, Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 1998 at 20-28 to 20-29 (Nov. 25, 1998). The impact of this statement was mitigated beginning in late 1998, when the City began disclosing, in its CAFRs attached to the Offering Statements, that it was not contributing to SDCERS at actuarially determined rates, but, as discussed at length above, the CAFR description of MP-1 was itself misleading and incomplete in numerous respects.

⁹⁹⁰ In its 2004 Report, V&E reached no conclusions about the materiality of the City's pension-related disclosure deficiencies. The 2004 Report noted, however, that "[s]tanding alone, City disclosure since 1996 has failed to provide investors...with adequate information to enable them to clearly understand the relationship between SDCERS and the City's General Fund and to fully evaluate the creditworthiness of the City." Paul S. Maco & Richard C. Sauer, Vinson & Elkins LLP, Report on Investigation, The City of San Diego, California's Disclosures of Obligation to Fund the San Diego Employees Retirement System and Related Disclosure Practices 1996–2004 with Recommended Procedures and Changes to the Municipal Code at 161 (Sept. 16, 2004). In its 2005 Draft, V&E concluded that the City's inaccurate disclosure of MP-1, the trigger, and MP-2, in combination, made the City's disclosures materially misleading. Paul S. Maco & Richard C. Sauer, Vinson & Elkins LLP, Potential Violations of the Federal Securities Laws by the City of San Diego and Associated Individuals at 8, 35, 111 (Draft July 15, 2005).

In summary, neither the City nor SDCERS properly disclosed MP-1 in any of their financial disclosure documents. Specifically, and most importantly, the SDCERS CAFR and the City's bond offering disclosures falsely stated or implied that the City was continuing to fund SDCERS at actuarially determined rates when in fact contributions were far below these rates. The City CAFR alluded to a difference between City contribution rates and actuarially determined rates but obscured and downplayed the nature and amount of the difference. As a result of these deficiencies, neither citizens nor investors were alerted properly to the fact that the City was not funding its pension system at actuarially required rates.

2. Disclosure Failures Related to the *Corbett* Litigation and Settlement

The *Corbett* action was filed on July 16, 1998.⁹⁹¹ City officials knew that a virtually identical claim had been successfully asserted in another California jurisdiction and that if the *Corbett* litigation were successful, it could result in a significant increase to the City's pension obligations.⁹⁹² Nonetheless, the City failed to disclose the existence of this litigation in its 1998 and 1999 CAFRs.⁹⁹³

By March 2000, the City had quantified the financial impact of the *Corbett* litigation and knew that it could be well over seven hundred million dollars.⁹⁹⁴ The *Corbett* settlement was approved by the

The 2005 Draft did state, however, in a footnote, that "much of the information concerning funding problems with the pension system was publicly available in some form and arguably part of the 'total mix of information available.'" Paul S. Maco & Richard C. Sauer, Vinson & Elkins LLP, Potential Violations of the Federal Securities Laws by the City of San Diego and Associated Individuals at 81, n.400 (Draft July 15, 2005). While an analysis of the total mix of information may be relevant to determining materiality and may be the basis of a defense for the City and/or SDCERS, it is unimportant here, since the mere occurrence of failures in the nature and sheer volume found at the City belies a central breakdown in controls.

⁹⁹¹ Complaint, *Corbett v. City Employees' Retirement System*, No. 722449 (Cal. Super. Ct. July 16, 1998).

⁹⁹² Letter from Keith W. Enerson, President, Retirement Board, to Michael T. Uberuaga, City Manager (July 1, 1998); *Ventura Co. Deputy Sheriffs' Assoc. v. Bd. of Retirement of Ventura Co. Employees' Retirement Assoc.*, 16 Cal. 4th 483, 940 P.2d 891 (Cal. 1997).

⁹⁹³ The City's failure to disclose the *Corbett* litigation was a violation of GASB 27. GASB 27 § 22(b) requires disclosure of factors that significantly affect the identification of trends in the amounts reported. Governmental Accounting and Financial Reporting Standards, Vol. II, GASB 27 § 22(b) (June 30, 2005). One such factor was the impact of the *Corbett* litigation on the calculation of retirement benefits and the City's calculated contribution to the pension system.

Vinson & Elkins concluded that "[t]he City did not disclose the *Corbett* litigation or settlement in its CAFRs for the relevant time period." Nonetheless, the V&E Report noted that "[t]he *Corbett* settlement was, of course, a public document and could have been obtained by any interested person." Paul S. Maco & Richard C. Sauer, Vinson & Elkins LLP, Report on Investigation, The City of San Diego, California's Disclosures of Obligation to Fund the San Diego Employees Retirement System and Related Disclosure Practices 1996–2004 with Recommended Procedures and Changes to the Municipal Code at 73-74 (Sept. 16, 2004). In its 2005 Report, Vinson & Elkins added the qualification that the settlement itself was of "arguable access to investors outside California." Paul S. Maco & Richard C. Sauer, Vinson & Elkins LLP, Potential Violations of the Federal Securities Laws by the City of San Diego and Associated Individuals at 44 (Draft July 15, 2005).

⁹⁹⁴ Presentation to City Council in Closed Session (March 14, 2000); Handwritten notes of Cathy Lexin (Feb. 8, 2000).

court on May 17, 2000.⁹⁹⁵ Nonetheless, the City continued to fail to disclose properly either the litigation, its settlement, or its potential financial impact in *any* of its CAFRs or its Preliminary Official Statements and Official Statements for all bond offerings after the *Corbett* settlement. The SDCERS CAFRs in fiscal years 2000 and 2001 contained a description of the terms of the *Corbett* settlement in the Subsequent Events section that was incomplete and misleading.⁹⁹⁶ This disclosure was wholly inadequate because it failed to disclose the changes to the calculation of retirement benefits, the resulting additional liability created at SDCERS, and the overall financial impact the settlement would have on the City.⁹⁹⁷

While the City's CAFRs were mostly silent about *Corbett*, the City did discuss *Corbett* in a Continuing Disclosure Annual Report ("Annual Report")⁹⁹⁸ issued on April 5, 2000, but in a misleading way.⁹⁹⁹ The Annual Report stated that a tentative settlement of *Corbett* had been reached, pursuant to which:

[A]dditional benefits to be paid to retired employees will be paid from sources other than [the] City's General Fund (or its enterprise funds). Active City employees will receive increased benefit payments to CERS commencing in the Fiscal Year ending June 30, 2001, which will represent an increase of 0.5% in the cost of benefits payable by the City from the General Fund and other funds of the City, in accordance with the current funding mechanism.¹⁰⁰⁰

⁹⁹⁵ Order and Judgment Approving Settlement of Class Action, *Corbett v. City Employees' Retirement System*, No. 722449 (Cal. Super. Ct. Apr. 4, 2000).

⁹⁹⁶ San Diego City Employees' Retirement System, Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 2000, at 38-43 (Nov. 22, 2000); San Diego City Employees' Retirement System, Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 2001, at 44-49 (Jan. 28, 2002). In addition, we note that because the settlement was finalized in May 2000, *Corbett* should not have been disclosed in the "Subsequent Events" section. A financial event is disclosed as a "subsequent event" when the event occurred after the date of the entity's financial statements (in this case June 30, 2000 and June 30, 2001), but before the issuance of the financial statement.

⁹⁹⁷ GASB 27 § 22(b) requires the City to disclose "[f]actors that significantly affect the identification of trends in the amounts reported." This includes changes in benefit provisions and actuarial methods and assumptions used. Governmental Accounting and Financial Reporting Standards, Vol. II, GASB 27 § 22(b) (June 30, 2005).

⁹⁹⁸ Annual Report of the City of San Diego Relating to \$33,430,000 Certificates of Participation, Series 1996A (Balboa Park and Mission Bay Park Capital Improvements Program), \$11,720,000 Refunding Certificates of Participation Series 1996B (Balboa Park and Mission Bay Park Capital Improvements Program, Series 1991), \$68,425,000 Public Facilities Financing Authority of the City of San Diego Taxable Lease Revenue Bonds, Series 1996A (San Diego Jack Murphy Stadium) for the Fiscal Year Ended June 30, 1999, at 18 (Apr. 5, 2000).

⁹⁹⁹ Vinson & Elkins found that the description of the *Corbett* settlement in the City's April 2000 Annual Report "would not give the otherwise uninformed reader an accurate understanding of the significance of this matter for the City's finances." Paul S. Maco & Richard C. Sauer, Vinson & Elkins LLP, Report on Investigation, The City of San Diego, California's Disclosures of Obligation to Fund the San Diego Employees Retirement System and Related Disclosure Practices 1996-2004 with Recommended Procedures and Changes to the Municipal Code at 74 (Sept. 16, 2004).

¹⁰⁰⁰ Annual Report of the City of San Diego Relating to \$33,430,000 Certificates of Participation, Series 1996A (Balboa Park and Mission Bay Park Capital Improvements Program), \$11,720,000 Refunding Certificates of Participation Series 1996B (Balboa Park and Mission Bay Park Capital Improvements Program, Series 1991), \$68,425,000 Public

By stating that the cost of the settlement related to retired employees would not be borne by the City's "General Fund," the City implied that the *Corbett* settlement would have no financial impact on the City. In fact, because a portion of the cost of the *Corbett* benefits would be borne by SDCERS Surplus Earnings, these costs would reduce SDCERS assets by an equivalent amount, thereby increasing the System's UAAL and the City's Annual Required Contribution, which includes an amortized portion of the UAAL.¹⁰⁰¹

The biggest failing in all of the disclosures by the City and SDCERS about *Corbett* concerned the *Corbett* "contingent" liabilities. As discussed above, the City and SDCERS decided that the City's new obligations under the *Corbett* settlement to employees who had already retired could be treated as "contingent" because they were to be paid out of Surplus Earnings, with payment deferred if Surplus Earnings were inadequate. The City and SDCERS then concluded that these "contingent" liabilities could be ignored in calculating the SDCERS UAAL. As we have seen, this treatment of *Corbett* "contingent" liabilities was completely improper. No one reading the City's or SDCERS's disclosure documents would have been alerted to the fact that the *Corbett* settlement created a huge new unrecorded and unfunded liability.¹⁰⁰²

3. Disclosure Failures Related to the MP-1 Trigger

The descriptions of MP-1 in the City CAFRs, the SDCERS CAFRs, and the City's bond offering documents did not adequately disclose the significance of the funded ratio floor (the "trigger") contained in MP-1. If that floor was breached, the City would have had to make a large balloon payment and/or significantly increase its annual contribution to SDCERS.¹⁰⁰³ The likelihood of this breach would have been of particular significance to purchasers of the City's debt because it could have impaired the City's ability to make its debt payments.

City and SDCERS officials became aware of sharply diminishing investment earnings as early as October 2001,¹⁰⁰⁴ and they were sensitive by this time, if not earlier, of the need to take steps to "ride

Facilities Financing Authority of the City of San Diego Taxable Lease Revenue Bonds, Series 1996A (San Diego Jack Murphy Stadium) for the Fiscal Year Ended June 30, 1999, at 18 (Apr. 5, 2000).

¹⁰⁰¹ Order and Judgment Approving Settlement of Class Action, *Corbett v. City Employees' Retirement System*, No. 722449, at 5-7 (Cal. Super. Ct. Apr. 4, 2000).

¹⁰⁰² The failure of the SDCERS Board to include the *Corbett* contingent liabilities in the calculation of pension liabilities is a violation of GASB 27, which requires statutory or contractual agreements to provide pension benefits to be included in the actuarial present value of total projected benefits. Governmental Accounting and Financial Reporting Standards, Vol. II, GASB 27 ¶ 10(a) (June 30, 2005).

¹⁰⁰³ Minutes, SDCERS Board Meeting at 20 (June 21, 2002); Letter from Constance M. Hiatt and Robert Blum to Lawrence Grissom, Retirement Administrator (Draft June 12, 2002); Memorandum from Daniel E. Kelley, Labor Relations Manager, to Honorable Mayor and City Council (Mar. 15, 2002).

¹⁰⁰⁴ E-mail from Terri Webster to Ed Ryan (Oct. 9, 2001).

through the next few years and keep a fiscally sound funding ratio.”¹⁰⁰⁵ In February 2002, the June 30, 2001 actuarial valuation was officially released, and City and SDCERS officials learned that the funded ratio had dropped from 97.3% to 89.9%.¹⁰⁰⁶ City and SDCERS officials explicitly acknowledged the risk of hitting the trigger, especially in light of a continued slump in investment earnings – “The 82% trigger point is looking WAY too close” – and considered ways to obtain a more current estimate of the funded ratio.¹⁰⁰⁷ The actuarial valuation in February 2002 alerted City and SDCERS officials to a significant risk that a further decline in the funded ratio could cause the MP-1 trigger to be breached and created a duty to disclose the financial impact on the City if this should occur.¹⁰⁰⁸

Three bond offerings occurred during the first half of 2002, including the Ballpark Bond offering.¹⁰⁰⁹ The Ballpark Bond offering was particularly significant. In August and September 2004, Terri Webster had explicitly expressed her concern about this offering, noting that the BRC Report should not “mess w/ballpark bonds,” *i.e.*, the BRC Report, which would negatively describe the City’s pension funding,

¹⁰⁰⁵ E-mail from Terri Webster to Cathy Lexin (Oct. 11, 2001).

¹⁰⁰⁶ Gabriel, Roeder, Smith & Co., San Diego City Employees’ Retirement System Annual Actuarial Valuation June 13, 2001, at 13 (Feb. 12, 2002); E-mail from Terri Webster to Ed Ryan (Feb. 12, 2002).

V&E found that the City Auditor’s Office was aware of the risk that the trigger might be hit only as early as the June 30, 2002 actuarial valuation, but stated that “[n]evertheless, the City failed to amend its disclosure to reflect its increased knowledge of problems with the funding of its retirement system.” Paul S. Maco & Richard C. Sauer, Vinson & Elkins LLP, Report on Investigation, The City of San Diego, California’s Disclosures of Obligation to Fund the San Diego Employees Retirement System and Related Disclosure Practices 1996–2004 with Recommended Procedures and Changes to the Municipal Code at 96 (Sept. 16, 2004). In its 2005 Report, V&E concluded that the City’s pension-related disclosures in the period leading up to MP-2 were materially misleading, based partially on the omission in such disclosures of the risk that the trigger might be hit. Paul S. Maco & Richard C. Sauer, Vinson & Elkins LLP, Potential Violations of the Federal Securities Laws by the City of San Diego and Associated Individuals at 74, 81 (Draft July 15, 2005). City Attorney’s Interim Report No. 2 found that the City withheld “adverse financial facts from investors in the City’s bonds” relating to the drop in SDCERS’s funding ratio towards the trigger, even as it became aware of the deterioration of the pension plan’s financial condition during fiscal year 2002. The report broadly concluded that the City’s disclosures from March 18, 2002 to June 30, 2003 were materially misleading in violation of federal securities laws, and relied partially on the City’s concealment of the risk that the trigger might be hit in reaching this conclusion. City Attorney Michael J. Aguirre, Interim Report No. 2 Regarding Possible Abuse, Illegal Acts or Fraud by City of San Diego Officials at 9, 103-110 (Feb. 9, 2005).

¹⁰⁰⁷ E-mail from Terri Webster to Mary Vattimo (Feb. 12, 2002).

¹⁰⁰⁸ GASB 27 § 22(b) requires the City to disclose “[f]actors that significantly affect the identification of trends in the amounts reported.” This includes changes in benefit provisions and actuarial methods and assumptions used. A breach of the MP-1 trigger provision would have a significant impact on the City’s contribution rate to SDCERS. This information should have been disclosed. Governmental Accounting and Financial Reporting Standards, Vol. II GASB 27 § 22(b) (June 30, 2005).

¹⁰⁰⁹ The City issued the following bond offerings: \$169,685,000 Public Facilities Financing Authority of the City of San Diego Lease Revenue Bonds, Series 2002 (Ballpark Project) (Feb. 14, 2002); \$93,200,000 City of San Diego, California 2002-03 Tax Anticipation Notes Series A (June 4, 2002); \$25,070,000 Public Facilities Financing Authority of the City of San Diego Lease Revenue Bonds Series 2002 B (Fire and Life Safety Facilities Project) (June 12, 2002).

should be delayed so it would not harm the Ballpark Bond offering.¹⁰¹⁰ She was well aware that the disclosure of a potential large drop in the funded ratio would negatively impact the City's credit rating, and chose not to disclose this negative information.¹⁰¹¹

In the period leading up to MP-2, the sharp decline in SDCERS's investment earnings and the imminent risk of blowing through the trigger were material facts that should have been disclosed. As discussed above, the risks to the City's fiscal health, inherent in MP-1, would have taken on additional significance as the funded ratio dropped toward the floor. The risk that the City would have to make a large balloon payment within a short period of time posed a threat to the City's ability to generate enough revenue in the year the balloon payment was due to satisfy all of its obligations for that year. That risk would have been material to an investor contemplating a purchase of the City's bonds.

The City issued two additional bond offerings in June 2002.¹⁰¹² By this time, City and SDCERS officials had obtained additional information that projected the trigger would be breached as of June 30, 2002, and began discussing alternative funding proposals to either change or remove the trigger.¹⁰¹³ By not disclosing the risk of the MP-1 trigger or even its existence in these bond offerings, City officials concealed material information from the investing public and violated the requirements to disclose factors that significantly affect the identification of trends in amounts reported under GASB 27.¹⁰¹⁴

4. Disclosure Failures Related to MP-2 and Its Aftermath

The SDCERS Board and the City approved MP-2 in November 2002, prior to the issuance of the City's 2002 CAFR.¹⁰¹⁵ MP-2 and its consequences for the financial condition of the City should have

¹⁰¹⁰ Handwritten Notes of Terri Webster (Aug. 31, 2001 and Sept. 10, 2001).

¹⁰¹¹ E-mail from Terri Webster to Ray Garnica (Mar. 18, 2002); E-mail from Dick Vortmann to Linc Ward cc to Terri Webster, April Boling, Joe Craver, Mary Ball, ariel001@san.it.com, vilaplana@scmv.com, mcurine@swsslw.com, and Andrew Poat (Jan. 3, 2002); Interview by the Audit Committee with Lakshmi Kommi (May 4, 2006) (Ms. Kommi recalled relying heavily on Terri Webster as she prepared the information that was presented to rating agencies, because of Ms. Webster's background regarding the pension system.).

¹⁰¹² \$93,200,000 City of San Diego, California 2002-03 Tax Anticipation Notes Series A (June 4, 2002); \$25,070,000 Public Facilities Financing Authority of the City of San Diego Lease Revenue Bonds Series 2002 B (Fire and Life Safety Facilities Project) (June 12, 2002).

¹⁰¹³ E-mail from Lawrence Grissom to Terri Webster (April 15, 2002); E-mail from Ed Ryan to Terri Webster (April 15, 2002); E-mail from Terri Webster to Elmer Heap and Michael Rivo cc to Cathy Lexin (April 17, 2002).

¹⁰¹⁴ GASB 27 ¶ 22(b) requires the City to disclose "[f]actors that significantly affect the identification of trends in the amounts reported." This includes changes in actuarial methods and assumptions used. Because a breach of the MP-1 trigger provision would have had a significant impact on the City's contribution rate to SDCERS, this information should have been disclosed. Governmental Accounting and Financial Reporting Standards, Vol. II, GASB 27 ¶ 22(b) (June 30, 2005).

¹⁰¹⁵ San Diego, Cal., Ordinance O-19121 (Nov. 18, 2002); San Diego City Council Resolution R-297336 (Nov. 18, 2002); Minutes, San Diego City Council Meeting at 8-9, 39-40 (Nov. 18, 2002); Minutes, SDCERS Board Meeting at 29-30 (Nov. 15, 2002).

been disclosed in the City's 2002 CAFR. Moreover, by the time the City filed its 2002 CAFR, some of the risks to the City's financial health posed by MP-1 were no longer potential – they had, in fact, been realized.¹⁰¹⁶ Among these risks was the significant decline in SDCERS's funded ratio, which was widely believed to have already breached MP-1's trigger of 82.3% for the June 30, 2002 actuarial valuation.¹⁰¹⁷ Nevertheless, the City's 2002 CAFR pension disclosure was essentially unchanged from that of prior years. MP-2 was not mentioned at all, and the discussion of MP-1, which continued to be misleading and incomplete, was now also obsolete.¹⁰¹⁸ The City's 2002 CAFR was materially deficient under GASB 27's

¹⁰¹⁶ Gabriel, Roeder, Smith & Co., San Diego Employees' Retirement System Annual Actuarial Valuation June 30, 2002 at 9, 13 (Jan. 9, 2003).

¹⁰¹⁷ Memorandum from Cathy Lexin, Human Resources Director, and Elmer Heap, Head Deputy City Attorney, to the Honorable Mayor and City Council (June 14, 2002); E-Mail from Terri Webster to Lawrence Grissom (Apr. 15, 2002); E-mail from Terri Webster to Cathy Lexin and Bruce Herring (Mar. 13, 2002); Gabriel, Roeder, Smith & Co., San Diego Employees' Retirement System Annual Actuarial Valuation June 30, 2002, at 13-14 (Jan. 9, 2003)

¹⁰¹⁸ San Diego, California, Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 2002, at 27-39 (Nov. 27, 2002). In contrast, the SDCERS FY 2002 CAFR, which was cross-referenced in the notes to the financial statements of the City's CAFR, did disclose certain aspects of MP-2. *Id.* at 27-38; San Diego City Employees' Retirement System, Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 2002 at 46 - 47 (Nov. 1, 2002). Under the caption "SUBSEQUENT EVENT DISCLOSURE – Benefit Enhancements" the SDCERS CAFR provided the following description:

As a result of the City of San Diego's collective bargaining process known as Meet and Confer, the retirement benefits for General Members were increased effective July 1, 2002 (FY 2003). The Retirement Benefit Calculation factor was increased from 2.25% to 2.50% per year of creditable service The actuarial valuation to be performed as of June 30, 2002, will incorporate these benefits enhancements and will include any associated liability of SDCERS.

The SDCERS CAFR also disclosed the growth of the shortfall in City contributions to SDCERS and described the rate increase that would come into effect after MP-2 was adopted. San Diego City Employees' Retirement System, Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 2002 at 46-47 (Nov. 1, 2002).

In its 2004 Report, V&E similarly found that the City did not disclose information concerning MP-2 in its 2002 CAFR, despite the fact that "[t]he adoption of MP2 had essentially rendered obsolete the City's footnote disclosure concerning its negotiated schedule of contributions to SDCERS," and therefore the City "should have amended that disclosure to reflect changed circumstances." Paul S. Maco & Richard C. Sauer, Vinson & Elkins LLP, Report on Investigation, The City of San Diego, California's Disclosures of Obligation to Fund the San Diego Employees Retirement System and Related Disclosure Practices 1996–2004 with Recommended Procedures and Changes to the Municipal Code at 95 (Sept. 16, 2004). In its 2005 Report, V&E restated these deficiencies in the City's 2002 CAFR and broadly concluded that "the Evidence Available to the Investigation strongly suggests that the City's disclosure during FY 2003-2004 was materially misleading." Paul S. Maco & Richard C. Sauer, Vinson & Elkins LLP, Potential Violations of the Federal Securities Laws by the City of San Diego and Associated Individuals at 103, 110 (Draft July 15, 2005). The City Attorney's Interim Reports did not specifically address the disclosures made in the City's 2002 CAFR.

standard for describing pension information because the City failed to disclose the MP-2 agreement and its key components.¹⁰¹⁹

The City's 2002 CAFR pension disclosure differed from prior years in only one significant respect – the statement referring to GASB's consideration of whether to add the "corridor funding" method to the list of approved expending methods was deleted.¹⁰²⁰ This statement was removed because the City, in late 2002, for the first time decided to confirm with the SDCERS actuary that this statement was correct, and was told by the actuary to remove the statement.¹⁰²¹ However, the City did not ask Mr. Roeder to verify the accuracy of any other statements in the pension footnote and it was not until September 2003 that Mr. Roeder became aware of other false statements in the City's disclosures.¹⁰²² Mr. Roeder wrote Mr. Grissom and Mr. Barnett an e-mail to inform them of the errors, and stated he would no longer agree that the "corridor funding" method is "excellent," because the City modified the trigger by implementing MP-2.¹⁰²³

The City bond offering documents from mid-2002 through 2003 were also completely silent about MP-2. Appendix A of the bond offering documents continued to describe the funding of SDCERS in the same manner as it had even prior to MP-1.¹⁰²⁴ Depending upon the bond offering, Appendix B contained excerpts from the City's 2001 or 2002 CAFR, which, as described above, were similarly deficient. Notwithstanding its significance, there was no relevant disclosure of MP-2 at all in the City's disclosure documents.

¹⁰¹⁹ GASB 27 § 22(b) requires the City to disclose "[f]actors that significantly affect the identification of trends in the amounts reported." This includes changes in benefit provisions and actuarial methods and assumptions used. Governmental Accounting and Financial Reporting Standards, Vol. II, GASB 27 § 22(b) (June 30, 2005). The City CAFR was also deficient with relation to GASB 34 § 11(h), which requires the Management's Discussion and Analysis section of the City CAFR to provide a "description of currently known facts, decisions, or conditions that are expected to have a significant effect on financial position...or results of operations." Governmental Accounting and Financial Reporting Standards, Vol. II, GASB 34 § 11(h) (June 30, 2005).

¹⁰²⁰ San Diego, California, Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 2002, at 27-39 (Nov. 27, 2002).

¹⁰²¹ E-mail from Cecelia San Pedro to Jeanne Cole (Sept. 18, 2003); Interview by the Audit Committee with Cecelia San Pedro (Apr. 25, 2006).

¹⁰²² E-mail from Rick Roeder to Lawrence Grissom, Paul Barnett, and Terri Webster (Sept. 9, 2003); E-mail from Rick Roeder to Lawrence Grissom and Paul Barnett (Sept. 5, 2003). In his lawsuit against Mr. Roeder's consultant group Gabriel, Roeder, Smith & Co. ("GRS"), the City Attorney did not specifically allege that Mr. Roeder reviewed or commented on the City CAFRs. First Amended Complaint, *City of San Diego v. Callan Associates, Inc.*, No. GIC 852419 (Cal. Super. Ct. Aug. 15, 2005).

¹⁰²³ E-mail from Rick Roeder to Lawrence Grissom, Paul Barnett, and Terri Webster (Sept. 9, 2003); E-mail from Rick Roeder to Lawrence Grissom and Paul Barnett (Sept. 5, 2003). Mr. Roeder also commented that the statement "The Net Pension Obligation is funded in a reserve" was false, as was the statement that the NPO would be eliminated if GASB approved the "corridor funding" method.

¹⁰²⁴ See, e.g., \$17,425,000 City of San Diego, 2003 Certificates of Participation (1993 Balboa Park and Mission Bay Park Refunding) at A-32 (May 29, 2003); but see \$59,465,000 Community Facilities District No. 1 (Miramar Ranch North), Special Tax Refunding, Series 1998 (June 24, 1998) (presenting this information in Appendix E).

SDCERS reported MP-2 as a subsequent event in its 2002 CAFR, and described the terms of MP-2 in detail in its 2003 CAFR. These descriptions, however, were silent as to the reasons for the MP-2 agreement.¹⁰²⁵ By June 30, 2003, it was known by SDCERS and the City that the SDCERS funded ratio had fallen below the 82.3% trigger, but the SDCERS CAFR for fiscal year 2003 failed to report this fact and the resulting impact on the City's contribution rate as required under GASB 25.¹⁰²⁶

As with the City's other disclosure deficiencies discussed above, the adoption and nature of MP-2 would have been material information for a reasonable investor. That the City's adoption of MP-2 was designed to avoid the impending balloon payment required by MP-1 demonstrates the severe fiscal strain increased pension contributions would have presented to the City at that time. Under the ramp-up funding provided for by MP-2, the UAAL would take longer to be paid off than under the balloon payment contemplated by MP-1, burdening the City's fiscal health for years to come. While City officials at the time of MP-2 were concerned only with short-term budget relief, the City's bondholders would have taken a long-term view of the City's ability to pay its debts. Pushing pension contributions onto future taxpayers would have been seen by investors as a material risk to the City's ability to repay its bonds in future years.

5. Disclosure Failures Related to Post-Retirement Healthcare

The City's disclosure related to its post-retirement healthcare liabilities was misleading in that it did not disclose that this benefit was paid, in part, using Surplus Earnings of SDCERS, and that the City's General Fund would bear the financial burden of financing the benefit in the event SDCERS Surplus Earnings were insufficient.¹⁰²⁷ The footnote for the 1996 CAFR included the following statement:

Currently, expenses for post-employment healthcare benefits are recognized as they are paid. For the fiscal year ended June 30, 1996, expenditures of approximately \$4,949,000 were recognized for such health care benefits.¹⁰²⁸

This statement was included in all City CAFRs from fiscal years 1996 through 2002, with appropriate updates to the current year cost.¹⁰²⁹ This disclosure is incomplete because it fails to provide important details

¹⁰²⁵ San Diego City Employees' Retirement System, Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 2003, at 47-49 (Dec. 1, 2003); San Diego City Employees' Retirement System, Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 2002, at 46-47 (Nov. 1, 2002).

¹⁰²⁶ Gabriel, Roeder, Smith & Co., San Diego Employees' Retirement System Annual Actuarial Valuation June 30, 2002, at 13-14 (Jan. 9, 2003); Governmental Accounting and Financial Reporting Standards, Vol. II, GASB 25 ¶ 32(c)(2) (June 30, 2005).

¹⁰²⁷ San Diego, Cal., Ordinance O-16510 (Sept. 30, 1985).

¹⁰²⁸ City of San Diego, California, Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 1996, at 18-33 (Nov. 27, 1996).

¹⁰²⁹ See, e.g., City of San Diego, California, Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 2002, at 27-43 (Nov. 27, 2002).

about the funding mechanism used to pay for this benefit. Additionally, it failed to describe the potential impact on the General Fund in the event SDCERS Surplus Earnings were insufficient. Since this benefit was first established, a significant portion of the cost was paid for either out of SDCERS's Surplus Earnings or from the City's regular pension contributions.

The City chose to ignore the recommendations of the 1989 Buck Report, the Blue Ribbon Committee, and its disclosure counsel that it should do an actuarial valuation of the retiree healthcare benefit.¹⁰³⁰ Terri Webster in particular appears to have persistently resisted the notion of analyzing future retiree healthcare costs. As outside disclosure counsel, Paul Webber pointed out in a December 10, 2003 e-mail to Lakshmi Kommi, "[i]t seems somewhat unusual that the City wouldn't have some idea what the general fund exposure might be for such an enormous amount of exposure, notwithstanding that there is not yet a requirement for actuarially determining the exposure."¹⁰³¹ Terri Webster, in response to Mr. Webber's concerns, informed him that the City Auditor's Office knows it will be "a big number" but neither SDCERS nor the City has conducted an actuarial valuation to determine the actual liability because it was not yet required to do so by GASB.¹⁰³²

Although the "Post Retirement Health Insurance" footnote in the City CAFR included information related to the current year cost of this benefit, the number of retirees who received the benefit, and a description of the retirees eligible for the benefit, the City failed to disclose the true funding method used to pay for this benefit as required by GASB 12. At a minimum, the footnote should have included a statement that the costs were funded by Surplus Earnings of SDCERS, and the City was responsible for paying the costs of this benefit in the event that SDCERS's Surplus Earnings were insufficient. GASB 12 requires an employer to disclose "a description of the accounting and financing or funding policies followed." Governmental Accounting and Financial Reporting Standards, Vol. II, GASB 12 § 10(c) (June 30, 2005).

¹⁰³⁰ Buck Consultants, City of San Diego Design and Funding Postretirement Medical Benefits, accompanied by cover letter to Jack McGrory, Assistant City Manager, City of San Diego at 3-4, 7 (Draft Apr. 24, 1989); Blue Ribbon Committee Report on City of San Diego Finances at 23 (Feb. 2002); E-mail from Paul Webber to Lakshmi Kommi and Paul Webber (Dec. 10, 2003).

While GASB did not formerly require municipalities such as San Diego to actuarially fund or disclose non-pension liabilities such as retiree healthcare as a general matter, GASB will require them to do so in the near future. Beginning in Fiscal Year 2008, GASB Statement Number 45 generally requires that state and local governmental employers account for and report the annual cost of such non-pension benefits and related obligations in essentially the same manner as they currently do for pensions. See, e.g., City of San Diego, California Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 2002, at 19 (Nov. 27, 2002). San Diego's total annual revenue is over \$100 million, which puts it into the first phase of implementation of GASB 45. "Phase 1" requires implementation of GASB 45 for periods beginning after December 15, 2006. Governmental Accounting and Financial Reporting Standards, Vol. II GASB 45 §§ 36-39 (June 30, 2005). GASB 45 is first effective for San Diego in the fiscal year beginning July 1, 2007 and ending June 30, 2008.

¹⁰³¹ E-mail from Paul Webber to Lakshmi Kommi (Dec. 10, 2003).

¹⁰³² E-mail from Terri Webster to Lakshmi Kommi and Paul Webber (Dec. 10, 2003).

Today, retiree healthcare benefits are no longer paid out of Surplus Earnings. In February 2005, the City Council adopted a recommendation of the Pension Reform Committee when it passed an ordinance requiring the use of the City's General Fund to pay for retiree healthcare costs.¹⁰³³

GASB did not require the City to disclose its post-retirement healthcare liability. Still, as discussed among the remediation measures, disclosure of this amount was and continues to be a preferable practice.

6. Accounting Failures Related to Reporting the Net Pension Obligation

A Net Pension Obligation is created when an employer fails to fully fund the Annual Required Contribution for its pension plan.¹⁰³⁴ Under MP-1, the City contributed toward its pension obligations at predetermined, negotiated rates which were less than a GASB-approved ARC.¹⁰³⁵ GASB guidance directed the City to disclose this divergence and report the cumulative difference between actual payments and payments determined under a GASB-approved actuarial funding method – the NPO – in its financial statements.¹⁰³⁶ In the CAFR for the fiscal year ended June 30, 1997, the City falsely stated: “There is no Net Pension Obligation at year end as Annual Required Contributions and Contributions Made have always been identical during the three year period [fiscal years 1995 through 1997].”¹⁰³⁷ In fact, the City should have recorded an NPO of at least \$6 million at this date because the City's contribution to SDCERS for that fiscal year was less than the ARC.¹⁰³⁸ In all subsequent years, the NPO figures reported by the City were out of date by a full year, which understated the NPO in those years.

Although the City included an NPO in its CAFRs for the fiscal years ending June 30, 1998, through June 30, 2002, its disclosure remained misleading. The CAFR pension footnote suggested that the

¹⁰³³ San Diego, Cal., Ordinance O-19354 (Feb. 1, 2005).

¹⁰³⁴ STEPHEN J. GAUTHIER, GOVERNMENTAL ACCOUNTING, AUDITING, AND FINANCIAL REPORTING: USING THE GASB 34 MODEL 274 (Government Finance Officers Association 2005).

¹⁰³⁵ Governmental Accounting and Financial Reporting Standards, Vol. II, GASB 27 ¶ 10 (June 30, 2005) (setting out approved actuarial cost methods); Letter from Rick A. Roeder to Larry Grissom (May 21, 1998).

¹⁰³⁶ Governmental Accounting and Financial Reporting Standards, Vol. II, GASB 27 ¶ 21(a) and 20(b)(3) (June 30, 2005). V&E concluded that “[t]he City tried but failed to comply with the requirements of GASB Statement No. 27 regarding disclosure of its NPO for the previous three years.” Paul S. Maco & Richard C. Sauer, Vinson & Elkins LLP, Report on Investigation, The City of San Diego, California's Disclosures of Obligation to Fund the San Diego Employees Retirement System and Related Disclosure Practices 1996–2004 with Recommended Procedures and Changes to the Municipal Code at 63 (Sept. 16, 2004). V&E did not provide any facts to support its conclusion that the City tried to comply with GASB 27.

¹⁰³⁷ City of San Diego, California, Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 1997, at 18-30 (Nov. 21, 1997).

¹⁰³⁸ City of San Diego, California, Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 1998, at 20-30 (Nov. 25, 1998).

NPO resulted from an accounting technicality that would be eliminated after the GASB adopted “Corridor” funding as an approved funding method.¹⁰³⁹ In fact, the GASB never adopted “Corridor” funding as an acceptable actuarial cost method. By the June 30, 2002 CAFR, this statement was misleading and should have been removed.

When the City initially reported an NPO at the end of 1998, more than two years after MP-1 was adopted, it attempted to minimize its significance. The City CAFR stated the NPO was “funded in a reserve,” a misleading statement repeated in all subsequent City CAFRs.¹⁰⁴⁰ The “reserve” was simply an amount equal to the City’s annual NPO which was carved out of SDCERS Surplus Earnings and placed in a separate account at SDCERS (and included in actuarial assets).¹⁰⁴¹ The reserve account was increased each year in an amount equal to the increase in the City’s reportable NPO. In 2003, the funds sitting in the NPO reserve account were transferred into the Employer Contribution reserve account.¹⁰⁴² This transfer had no effect on the funded status of SDCERS because both the NPO reserve account and the Employer Contribution Reserve account were included in actuarial assets. In fact, had the NPO reserve account not been created, the funds would have gone into the Employer Contribution Reserve instead. This “reserve” also did not reduce the gap, which continued to grow year by year, between what the City actually paid for retirement benefits and what it would have paid under a GASB-approved actuarial funding method.¹⁰⁴³ Furthermore, it is not clear how, even in theory, a reserve account at SDCERS could have offset a City liability.

In addition to the misleading disclosure of the existence of an NPO and whether it was funded in a “reserve,” several factors also resulted in a questionable calculation of the City’s NPO when an NPO was disclosed at all:

- The characterization of a portion of the *Corbett* settlement as “contingent” for purposes of the actuarial valuation also understated the City’s NPO. If the “contingent” liabilities had been accounted for properly, they would

¹⁰³⁹ See, e.g., City of San Diego, California, Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 1998, at 20-29 (Nov. 25, 1998).

¹⁰⁴⁰ See, e.g., City of San Diego, California, Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 1998, at 20-29 (Nov. 25, 1998).

¹⁰⁴¹ See, e.g., Gabriel, Roeder, Smith & Co., San Diego City Employees’ Retirement System Annual Actuarial Valuation June 30, 2001, at 22 (Feb. 12, 2002).

¹⁰⁴² At a SDCERS Special Retirement Board Meeting held on May 29, 2002, Lawrence Grissom indicated that the NPO reserve account was “created out of what appears to be a misunderstanding between . . . the actuary and Ms. Webster. Mr. Roeder has subsequently indicated that the Board doesn’t need to reserve this but simply needs to footnote this on the balance sheets.” Minutes, SDCERS Special Retirement Board Meeting at 22 (May 29, 2002).

¹⁰⁴³ Presentation, Actuarial Information re: Manager’s Proposal (June 12, 2002).

have significantly increased the SDCERS UAAL, which, in turn, would have increased the City's Annual Required Contribution each year. Because the City's actual contribution was fixed by MP-1, any increase in the ARC would have increased its NPO. The improper treatment of *Corbett* "contingent" liabilities thus caused a systematic understatement of the NPO, reduced the City's reported NPO, and artificially delayed the point at which the City would hit the 82.3% funded ratio trigger.¹⁰⁴⁴

- To reduce the ARC and the reported NPO, the City used a 40-year UAAL amortization period to determine the NPO.¹⁰⁴⁵ The effect of utilizing the longer amortization period decreased the calculated ARC, and, in turn, reduced the reported NPO. However, the SDCERS actuary continued to use and report a 30-year amortization period for preparing actuarial valuations and reporting required contribution levels for SDCERS but used a 40-year amortization period for the City to calculate the NPO. The effect of utilizing the longer amortization period decreased the NPO reported by the City in 1998 by approximately \$1.3 million.¹⁰⁴⁶ Although not violative of any GASB rule, the use of different amortization periods to calculate essentially the same thing for the sole purpose of making the City's NPO appear less dramatic was certainly not good practice.
- Since the mid-1980s, the City used a variety of methods to apply a portion of its annual contribution to SDCERS to post-retirement healthcare benefits. This effectively reduced the City's net contribution for pension benefits each year and decreased total plan assets. The NPO calculation should have included, but did not, annual amounts diverted for post-retirement healthcare payments.¹⁰⁴⁷ As a result, the NPO was further understated by an amount equivalent to payments for retiree healthcare.

The materiality of the City's false and misleading statements and omissions regarding the NPO, as well as other important facts about the pension system, is amply demonstrated by the City's deliberate efforts to conceal this information from the rating agencies. Indeed, prior to 2003, no information whatsoever regarding SDCERS was provided to any of the four rating agencies.¹⁰⁴⁸ Because the pension system was not discussed at all during presentations to the rating agencies, the agencies were unaware of (i) SDCERS's declining funded ratio; (ii) the City's concern over the MP-1 trigger being breached and the likely financial consequences to the City if it were; and (iii) the City's proposal that SDCERS agree to amend the

¹⁰⁴⁴ Letter from Rick A. Roeder to Larry Grissom (Mar. 30, 2000).

¹⁰⁴⁵ E-mail from Richard Roeder to Terri Webster (Oct. 8, 2003); Letter from Rick A. Roeder to Mike Phillips (Feb. 12, 1998).

¹⁰⁴⁶ E-mail from Richard Roeder to Terri Webster (Oct. 8, 2003); Letter from Rick A. Roeder to Mike Phillips (Feb. 12, 1998).

¹⁰⁴⁷ Letter from Rick A. Roeder to Mike Phillips (Feb. 12, 1998).

¹⁰⁴⁸ Interview by the Audit Committee with Lakshmi Kommi (May 4, 2006); *see, e.g.*, City of San Diego, Presentation to Standard & Poor's Rating Group (May 17, 2001).

MP-1 trigger in order to avoid those financial consequences. By failing to inform the rating agencies of the magnitude of the financial problems plaguing the SDCERS system, the City avoided the credit downgrade it feared, and the rating agencies left the City's high credit rating unchanged.¹⁰⁴⁹ The evidence suggests these omissions were not inadvertent, but rather were motivated by a concern that such disclosure could affect the City's credit rating and cause the cost of its borrowing to increase. As City Auditor Ed Ryan put it in 1998:

. . . [W]hen we book the NPO [showing the shortfall between the actuarially calculated contribution and what the City paid under MP-1] the rating agencies won't like it. It will be a negative for the City. As we market a large amount of bonds it might cost us a lot of money. Not quantifiable at the moment.¹⁰⁵⁰

As the SDCERS funding problems grew, so did concern on the part of City officials over the rating agencies' reaction to disclosure of the magnitude of the problem. Assistant City Auditor and Comptroller and SDCERS Board member Terri Webster underscored this concern in a July 2002 e-mail to Mr. Ryan:

Regarding Cathy [Lexin's] letter my biggest suggestion to her is to eliminate any reference to Fitch and rating agencies This letter will be seen by press and the city does not need to telegraph its pension problems to the rating agencies who don't research the topic to any great level now.¹⁰⁵¹

Ms. Webster was even more explicit in an e-mail sent earlier in 2002 to fellow SDCERS Board member Ray Garnica, in which she attempted to explain the significance of the funded ratio trigger contained in MP-1:

Rating Agency Impacts:

The Funding Ratio is a fiscal indicator of the health of the SDCERS fund which is a major fund of the City. A large drop in funding ratio or dropping below certain benchmarks could result in a negative impact to the City's credit rating. The City has a high credit rating which is vital to keep borrowing costs down for future issuances on the horizon such as for fire stations, main library, and branch libraries, etc.¹⁰⁵²

¹⁰⁴⁹ City officials' concern over the reaction of the rating agencies appears to have been prescient. After the SDCERS's funding problems were disclosed in February 2004, Fitch lowered its rating of City debt from AAA to AA, citing the decline in the funded ratio and the impact that rising pension costs would have on the City's financial flexibility. Fitch Ratings, Fitch Downgrades \$476.4MM City of San Diego, CA GOs, COPs & Lease Revs; Negative Outlook (Feb. 27, 2004). Standard & Poor's similarly lowered its rating, citing "increasing fiscal pressures" relating to the City's "burgeoning unfunded pension liability." Standard & Poor's, San Diego, CA's GO Debt Lowered to 'AA-': All Outstanding Bonds on CreditWatch Negative (Feb. 23, 2004).

¹⁰⁵⁰ E-mail from Ed Ryan to Terri Webster (Mar. 31, 1998).

¹⁰⁵¹ E-mail from Ed Ryan to Terri Webster (July 2, 2002).

¹⁰⁵² E-mail from Terri Webster to Ray Garnica (Mar. 18, 2002).

Misrepresentations of material fact made to rating agencies themselves constitute violations of the federal securities laws.¹⁰⁵³ Mr. Ryan's and Ms. Webster's e-mails demonstrate their intent to conceal patently material information about the City's NPO from the City's rating agencies, and therefore the City's bondholders, information they understood was critical to analyzing the City's fiscal health.¹⁰⁵⁴

7. Comparison to FASB Standards

In addressing the City's repeated failure to comply with accounting principles promulgated by the GASB, we do not contend that compliance with GASB, in comparative terms, would have afforded investors in municipal securities the transparency, comparability, and correspondingly, the protection enjoyed by purchasers of public company securities. Unfortunately, that is not the case today for the municipal bond market, one of the world's largest markets with \$1.7 trillion in invested capital, more than 50,000 state and

¹⁰⁵³ *SEC v. Coffey*, 493 F.2d 1304 (6th Cir. 1974) (holding that the SEC could proceed against an issuer for making misrepresentations to rating agencies under the broad umbrella of Rule 10b-5); *SEC v. DeSpain*, Litigation Release No. 19067, 2005 SEC LEXIS 275, at *1 (Feb. 8, 2005) (entering a permanent injunction against the former Assistant Treasurer of Enron based solely on his involvement in making misrepresentations to rating agencies); *In re Mount Sinai Medical Center of Florida, Inc., M. Brooks Turkel and Harvey W. Smith*, Securities Act Release No. 8580, 2005 SEC LEXIS 1314, at *1 (June 7, 2005) (entering a cease-and-desist order against a not-for-profit corporation for, among other things, making false and misleading statements to institutional investors and bond rating agencies in connection with municipal bond offerings); *In re County of Orange, California*, Securities Act Release No. 7260, 61 SEC Docket 310, 1996 WL 34362 (Jan. 24, 1996) (finding violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act where material misstatements were made in disclosure documents and to rating agencies).

While the 2004 V&E Report discussed at length the criteria used by rating agencies to evaluate the credit quality of a municipal issuer, this analysis served only as a constructive source of information the City could have drawn upon in deciding what disclosure of information was necessary. Paul S. Maco & Richard C. Sauer, Vinson & Elkins LLP, Report on Investigation, The City of San Diego, California's Disclosures of Obligation to Fund the San Diego City Employees' Retirement System and Related Disclosure Practices 1996-2004 with Recommended Procedures and Changes to the Municipal Code at 152-55 (Sept. 16, 2004). The Report does not reach a conclusion as to whether the City made misrepresentations to the rating agencies or whether such misrepresentations would be actionable by the SEC. The 2005 V&E Report acknowledged that a "fair inference from the record" could be drawn that City officials "may have avoided providing negative information to the rating agencies" to protect the City's credit rating. Paul S. Maco & Richard C. Sauer, Vinson & Elkins LLP, Potential Violations of the Federal Securities Laws by the City of San Diego and Associated Individuals at 78 (Draft July 15, 2005). However, the Report concluded that "a determination that [the failure to fully inform the rating agencies] violated the anti-fraud provisions of the securities laws would require a finding that the City had a legal duty to provide information to the rating agencies beyond that provided to the public. It is possible to fashion a legal theory to accommodate that view, however, it extends beyond anything asserted in SEC enforcement actions to date." *Id.* (footnote omitted). The City Attorney's Interim Report No. 2 only alluded to the possibility that the City had failed to disclose material facts to rating agencies. Stating that "[i]nvestors were kept in the dark about the trigger and balloon payment to the pension plan," the Report explained that Terri Webster understood that the disclosure of this information could lead to a drop in the City's credit rating. City Attorney Michael J. Aguirre, Interim Report No. 2 Regarding Possible Abuse, Illegal Acts and Fraud by City of San Diego Officials at 101 (Feb. 9, 2005). However, the Report did not specifically allege that City officials willfully misled rating agencies during presentations nor did it discuss the implications of such misrepresentations or omissions under the federal securities laws.

¹⁰⁵⁴ S.E.C. Release No. SAB - 99, 1999 WL 1123073, at *4 (Aug. 12, 1999) ("[T]he staff believes that a registrant and the auditors of its financial statements should not assume that even small intentional misstatements in financial statements...are immaterial. While the intent of management does not render a misstatement material, it may provide significant evidence of materiality.").

local entities issuing over 2 million separate outstanding bonds, and an estimated daily trading volume of \$11 billion.¹⁰⁵⁵ The lack of transparency under the GASB's standards puts investors at risk, particularly as compared to the accounting and financial standards promulgated for non-governmental entities (including public companies) by its predecessor, the Financial Accounting Standards Board ("FASB").

Several deficiencies in the GASB's accounting standards illustrate the GASB's relatively relaxed approach to governmental accounting:

- The GASB permits state and local governments to choose from six different actuarial methods to determine the amount of their pension liability.¹⁰⁵⁶ This flexibility results in a lack of comparability for investors who are trying to compare the risk of investing in the municipal securities of governments that utilize different actuarial methods. The GASB's standards are considerably more flexible than its private sector counterpart. The FASB requires private companies to all use the same method. This would have prevented the City of San Diego from changing from the EAN method to the PUC method to reduce its pension contributions in the short-term.
- The GASB standards permit long amortization periods for the recognition of unfunded liabilities – up to 40 years in the past, and, after 2007, up to 30 years.¹⁰⁵⁷ This has permitted governments to avoid recognizing expenses for services rendered in the past. It also permits governmental issuers to pass current or past costs for services on to future generations for funding. In some instances, municipalities have used much longer periods for amortizing unfunded costs, while amortizing unrecognized gains over a much shorter period of time. The GASB permits amortization as a level percentage of payroll – this usually results in negative amortization in the early years and further stretches out the amortization period. In addition, comparability amongst government issuers is reduced since each can select a different amortization period.
- The GASB only requires a governmental entity to conduct an actuarial valuation report on a biennial basis. To the contrary, the FASB requires public companies accessing the capital markets to have an actuarial valuation performed on an annual basis. Given that significant events can (and do) have a material impact on these actuarial valuations – such as the effect of a decline in the stock market, the granting of additional benefits, or even changes in

¹⁰⁵⁵ The Bond Market Association, About Municipal Bonds, *available at* <http://www.investinginbonds.com/learnmore.asp?catid=88&subcatid=82>.

¹⁰⁵⁶ Governmental Accounting and Financial Reporting Standards, Vol. II, GASB 27 ¶ 10(d) (June 30, 2005).

¹⁰⁵⁷ Governmental Accounting and Financial Reporting Standards, Vol. II, GASB 25 ¶ 42 and GASB 27 ¶ 10(f)(1) (June 30, 2005).

interest rates – updating these reports on an annual basis is essential to the provision of timely and relevant disclosure about the accuracy of the assumptions underpinning a pension plan.

- The GASB has only recently indicated that it will require governmental entities to actuarially fund and disclose non-pension-related liabilities, such as post-retirement healthcare costs, a requirement which will become effective beginning Fiscal Year 2008 through the implementation of GASB Statement Number 45.¹⁰⁵⁸ The FASB has long required public companies to account for and report the annual cost of Other Postretirement Benefits (“OPEB”) in essentially the same manner as they do for pensions. The GASB’s belatedness in implementing such a requirement further demonstrates the lack of transparency underlying its disclosure requirements.

Overall, as compared to the FASB’s approach to accounting and financial standards, the GASB has been slow to address certain disclosure and financial reporting issues, and its standards are considerably more lenient. The FASB has issued an exposure draft that would result in investors receiving balance sheets from companies in which they invest. The balance sheets would be required to reflect the net liability of the company’s pension and retiree healthcare obligations. The GASB has yet to undertake a similar project. The GASB standard on pension disclosure (GASB 27) was issued nine years after the FASB issued its comparable standard. The GASB standard on accounting for post-employment benefits other than pensions, such as healthcare costs, was issued in June 2004, over a decade after the FASB issued its comparable standard in December 1990. The FASB requires disclosure of information that the GASB does not, such as the pension benefits expected to be paid in each of the next five fiscal years and in the aggregate for the five fiscal years thereafter. That the GASB’s standards are more relaxed makes the City’s non-compliance with the GASB even more remarkable and the lack of transparency in the City’s disclosure even less excusable.

E. Wastewater Disclosure Deficiencies

1. Concealment from the Investing Public

Members of the City Manager’s Office, the City Attorney’s Office, the MWWD and others knew the City was violating its grant and loan covenants and also knew the potential consequences for such violation.¹⁰⁵⁹ Nonetheless, this information appears to have been concealed from the investing public, the City’s bond and disclosure counsel, and others until 2004.

¹⁰⁵⁸ Governmental Accounting and Financial Reporting Standards, Vol. II, GASB 45 (June 30, 2005).

¹⁰⁵⁹ E-mail from Dennis Kahlie to Mary Vattimo, Kelly Salt, George Loveland, Patricia Frazier, Richard Mendes, Eric Adachi, and Ed Ryan, with attached Salient Points Sewer Cost of Service Compliance Issue (Nov. 13, 2002); Interview by the Audit Committee with Ted Bromfield (Apr. 27, 2006); Interview by the Audit Committee with Bill

a. Bond Offerings

The City issued sewer revenue bonds as an additional means of financing wastewater projects. The first sewer revenue bond offering was in 1993, with subsequent offerings in 1995, 1997, and 1999. Another offering was initiated in 2003, but in light of other events within the City, the POS was pulled shortly before the bonds were to be offered.¹⁰⁶⁰

Preparation of the sewer POS was a collaborative and multi-disciplinary effort.¹⁰⁶¹ The working group consisted of members of the City Attorney's Office, the Auditor and Comptroller's Office, the City Manager's Office, Financing Services, the MWW, outside counsel, outside financial advisors, and others.¹⁰⁶² Paul Webber of Orrick Herrington & Sutcliffe served as outside counsel for each of the bond offerings.¹⁰⁶³ The drafting process entailed updating the OS from the prior offering to include any new developments. Individuals were assigned sections of the POS to update.¹⁰⁶⁴ Once they had done so, the working group met with Mr. Webber to walk through the POS page by page to discuss any changes or issues.¹⁰⁶⁵

Once the drafting process was complete, the offering proceeded like the others, as described above, with the City Council receiving a "1472" request for Council action, approving the POS, and

Hanley (Apr. 25, 2006); Interview by the Audit Committee with David Schlesinger (Apr. 24, 2006); Interview by the Audit Committee with Dennis Kahlie (Oct. 18, 2005).

¹⁰⁶⁰ Statement for Bond Buyer Re Wastewater Sale Delay (undated); \$505,550,000 2003 Public Facilities Financing Authority of the City of San Diego Subordinated Sewer Revenue Bonds, Series 2003A and Series 2003B ("Sept. [•], 2003"); Interview by the Audit Committee with Ed Wochaski (Apr. 20, 2006).

¹⁰⁶¹ Interview by the Audit Committee with Bill Hanley (Apr. 25, 2006); Interview by the Audit Committee with Ed Wochaski (Apr. 20, 2006).

¹⁰⁶² Required Items for the Wastewater System Preliminary Official Statement (Dec. 2, 1998); Interview by the Audit Committee with Dennis Kahlie (Oct. 18, 2005); Interview by the Audit Committee with Ed Wochaski (Apr. 20, 2006).

¹⁰⁶³ Interview by the Audit Committee with Dennis Kahlie (Oct. 18, 2005); Interview by the Audit Committee with Paul Webber (May 11, 2006).

The City Attorney has sued Orrick Herrington & Sutcliffe for professional negligence, breach of fiduciary duties, and breach of contract for its role in preparing and disseminating false and misleading disclosure documents. Complaint, *City of San Diego v. Orrick, Herrington & Sutcliffe*, No. GIC 857632 (Cal. Super. Ct. Nov. 29, 2005).

¹⁰⁶⁴ Required Items for the Wastewater System Preliminary Official Statement (Dec. 2, 1998); Interview by the Audit Committee with Ed Wochaski (Apr. 20, 2006); Interview by the Audit Committee with Paul Webber (May 11, 2006).

¹⁰⁶⁵ Interview by the Audit Committee with Ed Wochaski (Apr. 20, 2006); Interview by the Audit Committee with Paul Webber (May 11, 2006).

authorizing the offering to move forward.¹⁰⁶⁶ At some point after the City Council approved the POS, the City Manager's Office and the City Attorney's Office signed certifications verifying the accuracy of the contents of the disclosures.¹⁰⁶⁷ Outside bond counsel also issued an opinion in connection with the offerings.¹⁰⁶⁸ In the case of the sewer revenue bond offerings, Patricia Frazier signed the 1999 OS as the authorized representative of both the Public Facilities Financing Authority of the City of San Diego and the City of San Diego.¹⁰⁶⁹ City Manager McGrory signed all earlier ones.¹⁰⁷⁰ As the City Council had been told in 1997, disclosure obligations did not stop with the POS.¹⁰⁷¹ While the POS was the bond issuance's primary disclosure document, additional "[c]ontents deemed material by the City's disclosure counsel will be included in continuing disclosure."¹⁰⁷²

Since the first sewer revenue bond offering in 1993, the sewer OS contained language describing the City's sewer rate structure.¹⁰⁷³ The relevant language did not change in subsequent years.¹⁰⁷⁴ In

¹⁰⁶⁶ Interview by the Audit Committee with Ed Wochaski (Apr. 20, 2006); Interview by the Audit Committee with Brian Maienschein (May 12, 2006).

¹⁰⁶⁷ \$315,410,000 Public Facilities Financing Authority of the City of San Diego, Sewer Revenue Bonds, Series 1999A and Series 1999B at 56 (Mar. 2, 1999); Interview by the Audit Committee with Ed Wochaski (Apr. 20, 2006); Interview by the Audit Committee with Brian Maienschein (May 12, 2006).

¹⁰⁶⁸ \$315,410,000 Public Facilities Financing Authority of the City of San Diego, Sewer Revenue Bonds, Series 1999A and Series 1999B at E1-E3 (Mar. 2, 1999).

¹⁰⁶⁹ \$315,410,000 Public Facilities Financing Authority of the City of San Diego, Sewer Revenue Bonds, Series 1999A and Series 1999B at 56 (Mar. 2, 1999).

¹⁰⁷⁰ \$250,000,000 Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, Series 1993 at 41 (Sept. 30, 1993); \$350,000,000 Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, Series 1995 at 51 (Dec. 6, 1995); \$250,000,000 Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, Series 1997A and Series 1997B at 58 (May 15, 1997).

¹⁰⁷¹ City Manager's Report No. 97-03 at 2 (Jan. 8, 1997).

¹⁰⁷² City Manager's Report No. 97-03 at 2 (Jan. 8, 1997).

¹⁰⁷³ \$250,000,000 Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, Series 1993 at 22 (Sept. 30, 1993); \$350,000,000 Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, Series 1995 at 21 (Dec. 6, 1995); \$250,000,000 Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, Series 1997A and Series 1997B at 24 (May 15, 1997); \$315,410,000 Public Facilities Financing Authority of the City of San Diego, Sewer Revenue Bonds, Series 1999A and Series 1999B at 22-23 (Mar. 2, 1999).

¹⁰⁷⁴ \$250,000,000 Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, Series 1993 at 22 (Sept. 30, 1993); \$350,000,000 Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, Series 1995 at 21 (Dec. 6, 1995); \$250,000,000 Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, Series 1997A and Series 1997B at 24 (May 15, 1997); \$315,410,000 Public Facilities Financing Authority of the City of San Diego, Sewer Revenue Bonds, Series 1999A and Series 1999B at 22-23 (Mar. 2, 1999).

1995 and 1997, the language was likely false in light of what the City knew at the time, but by 1999 it was certainly so.

The pertinent section in the OS that describes the rate structure and related requirements is entitled “Wastewater System Regulatory Requirements.”¹⁰⁷⁵ Since 1993 and in each subsequent year, the OS stated that the City was subject to regulatory requirements as a condition of the City’s having received federal grant funds under the Clean Water Act. Further, it described that there is a proportionality requirement mandating that costs be recovered “in a proportionate manner according to the customer’s level of use.”¹⁰⁷⁶ Each offering listed the various factors that were required to be considered in determining “proportionality,” explaining that its own rates “are established to recognize the volume and strength characteristics of wastewater contributed to the Wastewater System.”¹⁰⁷⁷

As to whether its current rate structure complies with the SWRCB requirements, since 1993 the OS stated, “[t]he City’s rate structure has been reviewed by the State Board and no grant funds or costs under grant funded programs have been disallowed based on the nature of the rate structures.”¹⁰⁷⁸ This language appears to have been very carefully crafted. While it is arguably technically correct, it concealed the central fact that the City knew its rate structure did not comply with the identified requirements.¹⁰⁷⁹ The City was not just omitting the significant fact of its noncompliance with the SWRCB requirements and its

¹⁰⁷⁵ \$315,410,000 Public Facilities Financing Authority of the City of San Diego, Sewer Revenue Bonds, Series 1999A and Series 1999B at 22 (Mar. 2, 1999).

¹⁰⁷⁶ *See, e.g.*, \$315,410,000 Public Facilities Financing Authority of the City of San Diego, Sewer Revenue Bonds, Series 1999A and Series 1999B at 22 (Mar. 2, 1999).

¹⁰⁷⁷ \$315,410,000 Public Facilities Financing Authority of the City of San Diego, Sewer Revenue Bonds, Series 1999A and Series 1999B at 22 (Mar. 2, 1999). Although the word “strength” is most typically used to describe the measurement of organics, the City described it elsewhere in the OS to mean suspended solids, not organics. *Id.* at 32. (“Establishment, Calculation and Collection of Sewer Service Charges”): “Sewer service charges are based on the characteristics (volume of sewage, or flow, and suspended solids, or strength) of the wastewater discharged by each particular sewer user.”

¹⁰⁷⁸ \$250,000,000 Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, Series 1993 at 22 (Sept. 30, 1993); \$350,000,000 Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, Series 1995 at 21 (Dec. 6, 1995); \$250,000,000 Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, Series 1997A and Series 1997B at 24 (May 15, 1997); \$315,410,000 Public Facilities Financing Authority of the City of San Diego, Sewer Revenue Bonds, Series 1999A and Series 1999B at 22-23 (Mar. 2, 1999).

¹⁰⁷⁹ City Attorney Aguirre also concluded material information about the City’s compliance with rate structure requirements was not disclosed. He found evidence that the nondisclosure was intentional, specifically: “City officials did attempt to conceal, and did conceal, material information regarding the wastewater system’s noncompliant rate structure and the potential risk of forfeiture of Federal grants and State loans.” City Attorney Michael J. Aguirre, Wastewater Interim Report No. 1, City of San Diego Officials’ Failure to Disclose Material Facts in Connection with the Offer and Sale of Wastewater Bonds and Related Improper Activity at 19-20 (Sept. 15, 2005).

violation of its grant and loan covenants in making this statement. Worse, it was making an affirmative misstatement intended to give investors *comfort* about the status of the City's compliance.

The language regarding the City's rate structure was carried forward in each subsequent year's offerings, with slight modifications in each year.¹⁰⁸⁰ That the language changed with each offering demonstrates a conscious effort by the City to review and comment upon it. In certain respects the revisions indicate an intent to muddle, rather than to clarify, the description of the City's noncompliant status.¹⁰⁸¹

In the 1999 sewer revenue bond offering, the Wastewater Regulatory Requirements section concludes with the statement: "The City believes that it is in compliance with all federal and state laws relating to the Wastewater System."¹⁰⁸² In fact, the City was likely not in compliance with all federal laws, as its rate structure likely violated the proportionality requirement of the Clean Water Act. The City's failure to include COD had a significant adverse impact on residential users to the benefit of the industrial ones.¹⁰⁸³ In any event, whether or not the City actually was in violation of any federal or state laws, by 1999 it certainly thought it was.¹⁰⁸⁴ This statement was therefore made in spite of the City's belief to the contrary.

¹⁰⁸⁰ \$250,000,000 Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, Series 1993 at 22 (Sept. 30, 1993); \$350,000,000 Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, Series 1995 at 21 (Dec. 6, 1995); \$250,000,000 Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, Series 1997A and Series 1997B at 24 (May 15, 1997); \$315,410,000 Public Facilities Financing Authority of the City of San Diego, Sewer Revenue Bonds, Series 1999A and Series 1999B at 22-23 (Mar. 2, 1999). By the 1999 offering, Deputy City Attorney Kelly Salt was assigned to update and ensure the accuracy of this section. See Required Items for the Wastewater System Preliminary Official Statement (Dec. 2, 1998).

¹⁰⁸¹ A separate description of the PA's sewer rates was added in the 1995 OS the sentence immediately preceding the misleading one about the City's rate structure, to distinguish their rates from those of the City's own users. \$350,000,000 Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, Series 1995 at 21 (Dec. 6, 1995). The language again changed in the 1997 OS to expand the discussion about the City being subject to regulatory requirements, and in particular, the requirement to follow the SWRCB's Guidelines. \$250,000,000 Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, Series 1997A and Series 1997B at 24 (May 15, 1997). In the 1997 OS, one word was added directly to the misleading sentence about the City's rate structure, without any substantive or corrective effect. The word SWRCB was simply replaced so that the sentence then read that the rate structure had been "reviewed by the State Board and no grant funds or costs" had been disallowed. \$250,000,000 Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, Series 1997A and Series 1997B at 24 (May 15, 1997). In 1999, yet again, the language in the relevant paragraph was changed to remove the separate description of the PA's rate structure altogether. In its place, the City left one single description of all users' rate charges, which was described as structured to "recognize volume and strength characteristics of wastewater." \$315,410,000 Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, Series 1999A and Series 1999B at 22 (Mar. 2, 1999). This change was particularly misleading since the consolidation of the description of the City's and PA's rate structure left the distinct impression that both groups were billed based on the same methodology, when in fact, they were not.

¹⁰⁸² \$315,410,000 Public Facilities Financing Authority of the City of San Diego, Sewer Revenue Bonds, Series 1999A and Series 1999B at 23 (Mar. 2, 1999).

¹⁰⁸³ City of San Diego, Sewer Cost-of-Service Report Prepared by PinnacleOne for City of San Diego Financing Services at 4 (May 14, 1998).

¹⁰⁸⁴ Memorandum from Patricia T. Frazier, Financial and Technical Services Manager, to Coleman Conrad, Deputy City Manager (July 3, 1997).

Although the 2003 sewer revenue bonds were ultimately never offered, the POS was updated by the working group and approved by the City Council, and the offering was just days away from moving forward when the POS was pulled.¹⁰⁸⁵ In the course of revising the 2003 POS, Deputy City Attorney Ted Bromfield made substantial changes to the Regulatory Requirements section and even made a change to the paragraph about the City's rate structure.¹⁰⁸⁶ Although he knew by then about the City's noncompliance, he made no changes to the false language.¹⁰⁸⁷

The City's failure to comply with its legal obligations to have a proportional rate structure would have been material to the investing public and should have been disclosed. Indeed, Fitch, the bond rating agency, specifically inquired whether the City's rate structure was in compliance, demonstrating that this information mattered to investors. Given that a noncompliant rate structure could result in an obligation to immediately repay hundreds of millions of dollars, it is not surprising that Fitch would want to know more about the City's compliance (or lack thereof). Moreover, the City's cavalier approach to its legal obligations was itself material. Investors would want to know if City officials demonstrated a flagrant willingness to violate the law and knowingly risk disgorgement of hundred of millions of dollars in grant and loan funds. Such qualitative information about officials' integrity has been found by the SEC to be material.¹⁰⁸⁸ Particularly in 2003, on the heels of the implosions of Enron and Worldcom, investors were particularly focused on whether an entity had "tone at the top" deficiencies caused by leaders of an organization with a lack of respect for legal obligations.¹⁰⁸⁹

¹⁰⁸⁵ Interview by the Audit Committee with Ed Wochaski (Apr. 20, 2006); San Diego, Cal., Ordinance O-19194 (O-2003-161) (adopted June 30, 2002).

¹⁰⁸⁶ Mr. Bromfield revised the language to reflect that the City reviewed its rate structure "periodically" (striking out the word "annually"). Memorandum from City Attorney to Eric Adachi, City Rate Analyst, Jenna Magan, Bond Counsel, and Bill Hanley, MWWD Deputy Director (Apr. 24, 2003).

¹⁰⁸⁷ Memorandum from City Attorney to Eric Adachi, City Rate Analyst, Jenna Magan, Bond Counsel, and Bill Hanley, MWWD Deputy Director (Apr. 24, 2003); Interview by the Audit Committee with Ted Bromfield (Apr. 27, 2006).

¹⁰⁸⁸ SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45150, 45151 & n.5 (Aug. 19, 1999) ("[F]inancial management and the auditor must consider both 'quantitative' and 'qualitative' factors in assessing an item's materiality. . . . [Q]ualitative materiality refers to the surrounding circumstances that inform an investor's evaluation of financial statement entries."). See *Zell v. Intercapital Income Sec., Inc.*, 675 F.2d 1041, 1045 (9th Cir. 1982) (finding nondisclosed litigations potentially material since "[p]rior breaches of fiduciary duties or violations of securities statutes and regulations may have a direct bearing on managerial integrity"); *Takara Trust v. Molex Inc.*, 429 F. Supp. 2d 960, 979 (N.D. Ill. 2006) (qualitative factors bearing on materiality include whether misstatements or omissions affect a company's compliance with regulatory requirements); *In re Kidder Peabody Sec. Litig.*, 10 F. Supp. 2d 398, 411 (S.D.N.Y. 1998), *abrogated in part on other grounds* (holding that misstatements made by a subsidiary, apparently unbeknownst to its parent company, that allowed the parent company to "tout" the subsidiary's success and allay analysts' fears, were not immaterial as a matter of law and raised concerns about the parent company's "internal controls, efficiency, and integrity, all of which would have been relevant to a reasonable investor.").

¹⁰⁸⁹ Mark S. Schwartz, Thomas W. Dunfee, and Michael J. Kline, *Tone at the Top: An Ethics Code for Directors?*, 58 J. Bus. Ethics 79, 79-80 (Apr. 1, 2005); Donald T. Nicolaisen, Chief Accountant, U.S. Securities and Exchange

The City's failure to disclose its noncompliance in the 2003 POS is especially problematic. The City Council had received an ominous presentation on the issue in January 2002 and then, just months before approving the POS, had been given a legal memorandum in November 2002 from the City Attorney's Office that detailed the significant ramifications to the City for being out of compliance.¹⁰⁹⁰ The very fact that the City Council and City Attorney's Office planned to discuss the compliance issue in closed session (on at least two separate occasions) indicates they believed the issue created "significant exposure to litigation."¹⁰⁹¹

City officials not only hid or failed to disclose the City's noncompliance from the investing public, they also concealed it from their own bond and disclosure counsel. The weight of the evidence supports the conclusion that Mr. Webber was never told the City did not have a compliant rate structure nor that it was violating certain grant and loan covenants in its agreements with the State.¹⁰⁹² When Mr. Webber was finally informed of the issue by Councilmember Frye in February 2004, a Voluntary Disclosure was prepared and filed shortly thereafter, disclosing what Mr. Webber believed to be the material facts.¹⁰⁹³

b. Bond Offerings and Proposition 218

The City's bond disclosures were also inadequate with respect to Prop 218. Starting in 1997, the City took the position that Prop 218 did not likely apply to sewer charges, but that the City would nevertheless follow its requirements, since doing otherwise could have had a negative impact on its bond

Commission, Remarks before the 2003 Thirty-First AICPA National Conference on Current SEC Developments (Dec. 11, 2003).

¹⁰⁹⁰ Memorandum from Mary Vattimo, City Treasurer, and Kelly J. Salt, Deputy City Attorney, to Honorable Mayor and City Council (Nov. 14, 2002); Dennis Kahlie, Salient Points, Sewer Cost of Service Compliance Issue (Nov. 13, 2002); Interview by the Audit Committee with Dennis Kahlie (Oct. 18, 2005).

¹⁰⁹¹ San Diego City Council, Closed Session Report (Jan. 29, 2002). In a detailed letter to Councilmember Frye in November 2002, Les Girard emphasized the significance of the potential exposure and the need to discuss the issue in closed session. Memorandum from Leslie J. Girard, Assistant City Attorney, to Council Member Donna Frye (Nov. 18, 2002).

¹⁰⁹² E-mail from Paul Maco to Paul Webber (Feb. 12, 2004); SWRCB Grant/Loan Obligation Disclosure Issue (Apr. 26, 2004); Interview by the Audit Committee with Paul Webber (May 11, 2006); Interview by the Audit Committee with Ed Wochaski (Apr. 20, 2006); Interview by the Audit Committee with Dennis Kahlie (Oct. 18, 2005).

¹⁰⁹³ Annual Report for the Fiscal Year Ended June 30, 2003, Public Facilities Financing Authority of the City of San Diego, California, Sewer Revenue Bonds, Series 1995, Sewer Revenue Bonds, Series 1997A and Series 1997B, Sewer Revenue Bonds, Series 1999A and Series 1999B (Mar. 26, 2004).

issuances.¹⁰⁹⁴ Under current case law, sewer charges may in fact be subject to the proportionality requirement of Prop 218.¹⁰⁹⁵

The Prop 218 disclosure was added to the OS in 1997 at Mr. Webber's urging.¹⁰⁹⁶ It was carried forward in the 1999 OS and again in the 2003 POS.¹⁰⁹⁷ It quite thoroughly describes Prop 218 and its requirements and asserts, "[w]ithout conceding that its sewer rates and charges are subject to [Prop 218], the City believes that its rates comply with the foregoing standards."¹⁰⁹⁸ As described above, like the Clean Water Act, Prop 218 contains a proportionality requirement but does not detail how to set rates to satisfy that requirement. The City took the position in its March 2004 Voluntary Disclosure that, notwithstanding its failure to include COD in its rates, it believed it still met the proportionality requirements of Prop 218.¹⁰⁹⁹ The City also acknowledged in the Voluntary Disclosure the possible contrary conclusion, since the charges were "disproportionately better for certain commercial and industrial customers . . . and disproportionately worse for other customers."¹¹⁰⁰ Although there is little case law on point, like the Clean Water Act analysis,

¹⁰⁹⁴ Memorandum from City Attorney to George Loveland, Senior Deputy City Manager (July 31, 2001); Memorandum from Jack McGrory, City Manager, and Ed Ryan, City Auditor and Comptroller, to Honorable Mayor and City Councilmembers (Dec. 5, 1996).

¹⁰⁹⁵ See *Richmond v. Shasta Community Services District*, 32 Cal. 4th 409, 426-28 (Cal. 2004) (holding that water capacity fees and fire suppression fees are not subject to Prop 218 but reasoning in dicta that the "implication is strong" that charges for sewer user rates are property-related and thus subject to Prop 218); but see *Bighorn-Desert View Water Agency v. Beringson*, 120 Cal. App. 4th 890, 896-97 (2004) (on appeal to the California Supreme Court) (holding that water usage fees, analogous to sewer fees, are not subject to Prop 218 because they are not assessments "incident of property ownership" or fees for a "property related" service).

¹⁰⁹⁶ Interview by the Audit Committee with Paul Webber (May 11, 2006). To the extent there are any inadequacies with the Prop 218 disclosure, we conclude they relate to information that was withheld from outside bond counsel.

¹⁰⁹⁷ \$505,550,000 Public Facilities Financing Authority of the City of San Diego, Subordinated Sewer Revenue Bonds, Series 2003A and Series 2003B (Preliminary Official Statement) at 41-43 ("Sept. [•], 2003"); \$315,410,000 Public Facilities Financing Authority of the City of San Diego, Sewer Revenue Bonds, Series 1999A and Series 1999B at 37-38 (Mar. 2, 1999).

¹⁰⁹⁸ \$505,550,000 Public Facilities Financing Authority of the City of San Diego, Subordinated Sewer Revenue Bonds, Series 2003A and Series 2003B (Preliminary Official Statement) at 42 ("Sept. [•], 2003"); \$315,410,000 Public Facilities Financing Authority of the City of San Diego, Sewer Revenue Bonds, Series 1999A and Series 1999B at 37 (Mar. 2, 1999).

¹⁰⁹⁹ Annual Report for the Fiscal Year Ended June 30, 2003, Public Facilities Financing Authority of the City of San Diego, California, Sewer Revenue Bonds, Series 1995, Sewer Revenue Bonds, Series 1997A and Series 1997B, Sewer Revenue Bonds, Series 1999A and Series 1999B at 11 (Mar. 26, 2004).

¹¹⁰⁰ Annual Report for the Fiscal Year Ended June 30, 2003, Public Facilities Financing Authority of the City of San Diego, California, Sewer Revenue Bonds, Series 1995, Sewer Revenue Bonds, Series 1997A and Series 1997B, Sewer Revenue Bonds, Series 1999A and Series 1999B at 11 (Mar. 26, 2004).

since some users were adversely affected to the benefit of others, it seems clear that the City violated the proportionality requirement of Prop 218, and the disclosure should have reflected as much.¹¹⁰¹

There was an additional discrepancy in the City's sewer rate structure that also could be found to have violated Prop 218. Prior to incorporating COD into its rate structure, the City calculated its residential users' charges on one basis (how much water they used in winter months) while it charged its industrial users on a different basis.¹¹⁰² It is likely that this disparate treatment also violated the proportionality requirement of Prop 218.

c. Continuing Disclosures

In addition to issuing bonds, the City also filed periodic sewer bond continuing disclosure annual reports, for which Patricia Frazier and Mary Vattimo were largely responsible. On February 28, 2001, for example, Mary Vattimo and Patricia Frazier each signed a continuing disclosure that made no mention of the rate issue.¹¹⁰³ The following year, on March 4, 2002, Ms. Vattimo and Lakshmi Kommi each signed the continuing disclosure. Just as the one before it, this continuing disclosure failed to alert the public to either the City's noncompliance or of its potential liability.¹¹⁰⁴ This omission is particularly glaring given that, just one month prior to Ms. Vattimo signing the disclosure in March 2002, she and Ms. Frazier received the piercing e-mail from Dennis Kahlie, described above, in which he warned that he believed the City was in breach of eight grant and loan contracts, totaling \$410 million.¹¹⁰⁵ He cautioned: "As to when the hammer drops, it could literally happen at any time after [the] SWRCB concludes the City has begun to drag its feet."¹¹⁰⁶ This e-mail apparently had no effect on Ms. Vattimo or Ms. Frazier when they shortly thereafter prepared the continuing disclosure, and recklessly failed to disclose the City's noncompliance.

¹¹⁰¹ Similarly, Mr. Aguirre concluded the City's disclosures regarding Proposition 218 were "misleading to say the least." Acknowledging the ongoing debate about the applicability of Prop 218 to sewer fees and charges, Mr. Aguirre nevertheless found that the City's representation that it was in compliance with Prop 218's requirements "gloss[ed] over the obvious issue of non-compliance." City Attorney Michael J. Aguirre, *Wastewater Interim Report No. 1, City of San Diego Officials' Failure to Disclose Material Facts in Connection with the Offer and Sale of Wastewater Bonds and Related Improper Activity* at 15-16 (Sept. 15, 2005).

¹¹⁰² Facsimile from Kelly Salt to Dennis Kahlie (Nov. 16, 1999).

¹¹⁰³ Cheryl Mercer, Cover Memorandum, Continuing Disclosure Annual Report (Feb. 28, 2001).

¹¹⁰⁴ Cheryl Mercer, Cover Memorandum, Continuing Disclosure Annual Reports (Mar. 4, 2002).

¹¹⁰⁵ E-mail from Dennis Kahlie to Mary Vattimo and Patricia Frazier (Feb. 1, 2002).

¹¹⁰⁶ E-mail from Dennis Kahlie to Mary Vattimo and Patricia Frazier (Feb. 1, 2002).

d. Annual Financial Reports (City and Utilities)

Like the bond offerings, the City's CAFRs also failed to disclose the City's noncompliance with grant and loan conditions and its violations of law. NCGA Interpretation 6, applicable during the time period of the City's noncompliance, required the City to disclose in its financial statements "material violations of finance-related legal and contractual provisions."¹¹⁰⁷ SAB 99 states "the omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item."¹¹⁰⁸ Misstatements are not immaterial simply because they fall beneath a quantitative threshold, and a misstatement of even a relatively small amount could have a material effect on a financial statement.¹¹⁰⁹

The City's violation of conditions of its grant and loan agreements with the State was material and should have been disclosed in the City's CAFR. In fact, the CAFR footnotes contain a section dedicated to "Contingencies" designed with such disclosure in mind.¹¹¹⁰ This note, which was repeated year after year, stated:

The City has received federal and state grants for specific purposes that are subject to review and audit by the grantor agencies. Such audits could lead to requests for reimbursement to the grantor agency for expenditures disallowed under terms of the grant. City management believes such disallowances, if any, would not have a material effect on the City's financial position.¹¹¹¹

Disclosure of the City's noncompliance was never made in the City's "Contingencies" note. In fact, a disclosure about Prop 218 was added to the note for the CAFR for fiscal year 1997, but the note still omitted

¹¹⁰⁷ National Council on Governmental Accounting Interpretation 6, Notes to the Financial Statements Disclosure at ¶ 4 (May 1982). This failure is also a violation of the GASB 10 requirement to disclose a loss contingency when there is at least a reasonable possibility that a loss may have been incurred. Governmental Accounting and Financial Reporting Standards, Vol. II, GASB 10 ¶ 58 (June 30, 2005).

¹¹⁰⁸ SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45150, 45151 (Aug. 19, 1999).

¹¹⁰⁹ SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45150, 45152 (Aug. 19, 1999).

¹¹¹⁰ Governmental Accounting and Financial Reporting Standards, Vol. II, GASB 10 ¶ 58 (June 30, 2005).

¹¹¹¹ City of San Diego, California, Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 1996, at 18-40 n.17 (Nov. 27, 1996); City of San Diego, California, Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 1997, at 18-40 n.17 (Nov. 21, 1997); City of San Diego, California, Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 1998, at 20-40 n. 17 (Nov. 25, 1998); City of San Diego, California, Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 1999, at 20-40 n.17 (Nov. 30, 1999); City of San Diego, California, Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2000, at 20-41 n.18 (Nov. 30, 2000); City of San Diego, California, Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2001, at 20-42 n.18 (Nov. 30, 2001); City of San Diego, California, Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2002, at 27-47 n.18 (Nov. 27, 2002).

any disclosure about the City's violation of conditions of its grants and loans.¹¹¹² Likewise, the "Commitments" note of the City's CAFR contained an annual disclosure about the Sewer Utility's construction plans. The note described the City's intention to finance construction projects "with approved State and Federal grants," making no mention of the City's noncompliance with regard to these funds.

The MWWD also files its own financial report (the "MWWD Financials") on an annual basis. Like the CAFR, these financials should have disclosed the City's violation of contractual provisions.¹¹¹³ Yet year after year, the MWWD Financials were silent on the issue.¹¹¹⁴ These financials, like the CAFR, included a letter from Ed Ryan in which he recklessly certified the financials were accurate in all material respects.¹¹¹⁵ Moreover, beginning in 1998, the MWWD Financials contained a note directly addressing sewer

¹¹¹² This disclosure was carried forward until 2002 and related to a discussion about Prop 218 generally rather than to sewer fees specifically. It disclosed that certain taxes imposed after January 1, 1995, that did not meet Prop 218's requirements would be repealed, and this loss of revenue to the City could therefore adversely impact services funded by the expected revenue. City of San Diego, California, Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 1997, at 18-40 n.17 (Nov. 21, 1997); City of San Diego, California, Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 1998, at 20-40 n.17 (Nov. 25, 1998); City of San Diego, California, Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 1999, at 20-40 n.17 (Nov. 30, 1999); City of San Diego, California, Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2000, at 20-41 n.18 (Nov. 30, 2000); City of San Diego, California, Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2001, at 20-42 n.18 (Nov. 30, 2001); City of San Diego, California, Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2002, at 27-47 n.18 (Nov. 27, 2002).

¹¹¹³ Governmental Accounting and Financial Reporting Standards, Vol. II, GASB 10 § 58 (June 30, 2005); National Council on Governmental Accounting, Interpretation 6, Notes to the Financial Statements Disclosure at § 4 (May 1982); SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45150, at * 45152 (Aug. 19, 1999).

¹¹¹⁴ City of San Diego, California, Water Utilities Department 1993 Annual Financial Report for the Fiscal Year Ended June 30, 1993, at 11 (Nov. 1993); City of San Diego, California, Water Utilities Department 1994 Annual Financial Report for the Fiscal Year Ended June 30, 1994, at 13 (Nov. 1994); City of San Diego, California, Water Utilities Department 1995 Annual Financial Report for the Fiscal Year Ended June 30, 1995, at 11 (Dec. 29, 1995); City of San Diego, California, Metropolitan Wastewater Department 1996 Annual Financial Report for Fiscal Year Ended June 30, 1996, at 9 (Nov. 28, 1996); City of San Diego, California, Metropolitan Wastewater Department 1997 Annual Financial Report for Fiscal Year Ended June 30, 1997, at 9 (Nov. 27, 1997); City of San Diego, California, Metropolitan Wastewater Department 1998 Annual Financial Report for Fiscal Year Ended June 30, 1998, at 9 (Nov. 25, 1998); City of San Diego, California, Metropolitan Wastewater Department 1999 Annual Financial Report for Fiscal Year Ended June 30, 1999, at 9 (Nov. 30, 1999); City of San Diego, California, Metropolitan Wastewater Department 2000 Annual Financial Report for Fiscal Year Ended June 30, 2000, at 9 (Dec. 2000); City of San Diego, California, Metropolitan Wastewater Department 2001 Annual Financial Report for Fiscal Year Ended June 30, 2001, at 11 (Nov. 30, 2001); City of San Diego, California, Metropolitan Wastewater Utility 2002 Annual Financial Report for Fiscal Year Ended June 30, 2002, at 11 (Dec. 2002).

¹¹¹⁵ City of San Diego, California, Water Utilities Department 1993 Annual Financial Report for the Fiscal Year Ended June 30, 1993, at 11 (Nov. 1993); City of San Diego, California, Water Utilities Department 1994 Annual Financial Report for the Fiscal Year Ended June 30, 1994, at 13 (Nov. 1994); City of San Diego, California, Water Utilities Department 1995 Annual Financial Report for the Fiscal Year Ended June 30, 1995, at 11 (Dec. 29, 1995); City of San Diego, California, Metropolitan Wastewater Department 1996 Annual Financial Report for Fiscal Year Ended June 30, 1996, at 9 (Nov. 28, 1996); City of San Diego, California, Metropolitan Wastewater Department 1997 Annual Financial Report for Fiscal Year Ended June 30, 1997, at 9 (Nov. 27, 1997); City of San Diego, California, Metropolitan Wastewater Department 1998 Annual Financial Report for Fiscal Year Ended June 30, 1998, at 9 (Nov. 25, 1998); City of San Diego, California, Metropolitan Wastewater Department 1999 Annual Financial Report for Fiscal Year Ended June 30, 1999, at 9 (Nov. 30, 1999); City of San Diego, California, Metropolitan Wastewater Department 2000 Annual Financial Report for Fiscal Year Ended June 30, 2000, at 9 (Dec. 2000); City

rate billing and describing that the PA's billing structure included an allocation to COD.¹¹¹⁶ The note failed to mention that (1) the City's own users were not billed in that manner, and (2) the City was out of compliance with the SWRCB's Guidelines precisely because of the way the City's users were being billed.

e. Communications with Rating Agencies

On top of making misrepresentations to and withholding information from investors, the City similarly withheld information from rating agencies and made knowing misrepresentations to them.¹¹¹⁷ In June 2003, in anticipation of the upcoming bond offering, the City made a series of presentations to rating agencies.¹¹¹⁸ The City listed as one of its "Management Goals" in its presentation that it intends to "Continue to comply with State and Federal Regulations."¹¹¹⁹ In fact, while Mr. Kahlie, Mr. Hanley, and others who had the opportunity to revise the presentation knew the City was not meeting that goal, contrary affirmative misrepresentations were made to the rating agencies anyway.¹¹²⁰

Moreover, in the same time period, a Fitch representative posed five direct questions to the City, one of which was: "I understand the state board must 'approve' MWWWD's rate structure. Is this correct and if so, has the board ever not approved or had any significant input into MWWWD's rate structure?"¹¹²¹ The fact that the rating agency included this question as one of only five questions it asked

of San Diego, California, Metropolitan Wastewater Department 2001 Annual Financial Report for Fiscal Year Ended June 30, 2001, at 11 (Nov. 30, 2001); City of San Diego, California, Metropolitan Wastewater Utility 2002 Annual Financial Report for Fiscal Year Ended June 30, 2002, at 11 (Dec. 2002).

¹¹¹⁶ City of San Diego, California, Metropolitan Wastewater Department 1998 Annual Financial Report for Fiscal Year Ended June 30, 1998, at 31 n.7 (Nov. 25, 1998); City of San Diego, California, Metropolitan Wastewater Department 1999 Annual Financial Report for Fiscal Year Ended June 30, 1999, at 31 n.7 (Nov. 30, 1999); City of San Diego, California, Metropolitan Wastewater Utility 2000 Annual Financial Report for Fiscal Year Ended June 30, 2000, at 29 n.7 (Dec. 2000); City of San Diego, California, Metropolitan Wastewater Department 2001 Annual Financial Report for Fiscal Year Ended June 30, 2001, at 31 n.7 (Nov. 30, 2001); City of San Diego, California, Metropolitan Wastewater Utility 2002 Annual Financial Report for Fiscal Year Ended June 30, 2002, at 39 n.7 (Dec. 2002).

¹¹¹⁷ Mr. Aguirre did not address the City's misrepresentations to rating agencies in his Wastewater Interim Report No. 1. City Attorney Michael J. Aguirre, Wastewater Interim Report No. 1, City of San Diego Officials' Failure to Disclose Material Facts in Connection with the Offer and Sale of Wastewater Bonds and Related Improper Activity (Sept. 15, 2005)

¹¹¹⁸ E-mail from Lara Orr to Dennis Kahlie and Eric Adachi (June 23, 2003); City of San Diego Metropolitan Wastewater Department Presentation to Standard & Poor's (June 25, 2003).

¹¹¹⁹ City of San Diego Metropolitan Wastewater Department Presentation to Standard & Poor's at 14 (June 25, 2003).

¹¹²⁰ E-mail from Bill Hanley to Mark Capell, Dennis Kahlie, and Eric Adachi (July 1, 2003); City of San Diego Metropolitan Wastewater Department Presentation to Standard & Poor's (June 25, 2003); E-mail from Lara Orr to Dennis Kahlie and Eric Adachi (June 23, 2003); Interview by the Audit Committee with Bill Hanley (Apr. 25, 2006).

¹¹²¹ E-mail from Mark Capell to Bill Hanley (June 27, 2003).

strongly suggests both that it was important to the rating agency, and the City was specifically aware of the importance of the issue. Mr. Kahlie and Mr. Hanley concocted a misleading response which Mr. Hanley then e-mailed to Fitch.¹¹²² The response was: “The Board has periodically provided input to MWWD concerning its rate structure and changes thereto, but has never disapproved the structure or any component thereof.”¹¹²³ Mr. Hanley candidly admitted he was intentionally “sidestepping” the issue of the City’s lack of an approved rate structure.¹¹²⁴ He was concerned that if the rating agency knew the City was not in compliance, it could have had a negative impact on the upcoming 2003 bond offering and might affect how much money the City could raise.¹¹²⁵

Mr. Hanley’s testimony on this point likely explains why the noncompliance had not been disclosed in any public context at all over the course of the prior decade. The belief that the issue could potentially harm the City caused it to withhold the information.

2. The March 2004 Voluntary Disclosure: Concerns About the City’s Wastewater Disclosures Come to Light

On February 11, 2004, Mr. Webber appeared before the City Council in closed session, and, following that meeting, had a conversation with Councilmember Frye in which she told him about the City’s noncompliance and the State’s demand.¹¹²⁶ That was the first Mr. Webber had heard of it and he immediately inquired further.¹¹²⁷

As a result of Mr. Webber’s inquiries, the City made a corrective disclosure. On March 26, 2004, when the City issued its Sewer Revenue Bond Annual Report pursuant to the City’s regular continuing disclosure obligations, it disclosed that it did not have an approved sewer rate structure that was a condition of its receipt of approximately \$266 million in Clean Water Act grants and loans.¹¹²⁸ The City further disclosed: “If the City does not bring the Wastewater System’s user charge system into compliance, the City could be

¹¹²² E-mail from Bill Hanley to Mark Capell, Dennis Kahlie, and Eric Adachi (July 1, 2003).

¹¹²³ E-mail from Bill Hanley to Mark Capell, Dennis Kahlie, and Eric Adachi (July 1, 2003).

¹¹²⁴ Interview by the Audit Committee with Bill Hanley (Apr. 25, 2006).

¹¹²⁵ Interview by the Audit Committee with Bill Hanley (Apr. 25, 2006).

¹¹²⁶ E-mail from Paul Maco to Paul Webber (Feb. 12, 2004).

¹¹²⁷ E-mail from Paul Maco to Paul Webber (Feb. 12, 2004).

¹¹²⁸ Annual Report for the Fiscal Year Ended June 30, 2003, Public Facilities Financing Authority of the City of San Diego, California, Sewer Revenue Bonds, Series 1995, Sewer Revenue Bonds, Series 1997A and Series 1997B, Sewer Revenue Bonds, Series 1999A and Series 1999B at 9 (Mar. 26, 2004).

forced to repay the aggregate amount of the Clean Water Grants and repay the outstanding principal amount of the SRF loans.”¹¹²⁹

The Annual Report also addressed whether the City’s sewer rates were in compliance with Prop 218’s proportionality requirement.¹¹³⁰ The City stated that it believed its sewer rates complied, but recognized: “An argument could be made, however, that the sewer service charges do not comply with the Proportionality Requirement because those charges are disproportionately better for certain commercial and industrial customers of the Wastewater System that discharge large volumes of organic material, and disproportionately worse for other customers that do not.”¹¹³¹ The Annual Report also attempted to quantify the City’s liability should its sewer rate structure be found to violate Prop 218:

[I]n such event potential remedies could include a court order correcting the rate structure and a potential refund to customers who were overcharged, subject to any applicable statute of limitations. On the latter point, the City believes that the maximum annual revenue that could be subject to a refund is approximately \$2.5 million per year. The City Attorney is of the opinion that only claimants who make claims for refunds within four years of payment would be entitled to bring an action against the City.¹¹³²

These issues should have been disclosed years earlier. It is plain that Paul Webber, the City’s outside disclosure counsel, believed that the City’s noncompliance was an important fact to disclose. Had he been told of the noncompliance years earlier, the issue would likely never have been hidden from the investing public.

¹¹²⁹ Annual Report for the Fiscal Year Ended June 30, 2003, Public Facilities Financing Authority of the City of San Diego, California, Sewer Revenue Bonds, Series 1995, Sewer Revenue Bonds, Series 1997A and Series 1997B, Sewer Revenue Bonds, Series 1999A and Series 1999B at 9 (Mar. 26, 2004).

¹¹³⁰ Annual Report for the Fiscal Year Ended June 30, 2003, Public Facilities Financing Authority of the City of San Diego, California, Sewer Revenue Bonds, Series 1995, Sewer Revenue Bonds, Series 1997A and Series 1997B, Sewer Revenue Bonds, Series 1999A and Series 1999B at 11-14 (Mar. 26, 2004).

¹¹³¹ Annual Report for the Fiscal Year Ended June 30, 2003, Public Facilities Financing Authority of the City of San Diego, California, Sewer Revenue Bonds, Series 1995, Sewer Revenue Bonds, Series 1997A and Series 1997B, Sewer Revenue Bonds, Series 1999A and Series 1999B at 11 (Mar. 26, 2004).

¹¹³² Annual Report for the Fiscal Year Ended June 30, 2003, Public Facilities Financing Authority of the City of San Diego, California, Sewer Revenue Bonds, Series 1995, Sewer Revenue Bonds, Series 1997A and Series 1997B, Sewer Revenue Bonds, Series 1999A and Series 1999B at 12 (Mar. 26, 2004).